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Supreme Court, U.S.
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No.

In the
Supreme Court of the United States

THE STATE OF OKLAHOMA ex rel.
OFFICE OF STATE FINANCE,

Petitioner,

vs.

TOMMY G. THOMPSON, SECRETARY OF HEALTH AND HUMAN SERVICES ex rel DEPARTMENT OF HEALTH AND HUMAN SERVICES AND UNITED STATES OF AMERICA

Respondents.

On Petition For A Writ of Certiorari
To The Tenth Circuit Court of Appeals

PETITION FOR WRIT OF CERTIORARI

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The federal government reimburses the State of Oklahoma for the salary and fringe benefits paid to state employees who work on federal programs. The State pays each employee, as part of compensation, a fringe benefit called a benefit allowance, which the employee then uses to purchase insurance benefits of choice, either with a private health maintenance organization or the State's health insurance plan. In 1997, state employees who chose to use the benefit allowance to purchase health insurance from the State's plan received all coverage purchased. However, the State used a portion of these employee paid premiums for other governmental purposes, which the federal government disallowed under federal regulation, OMB A-87.

QUESTIONS PRESENTED

1. Whether OMB A-87, as applied, is an improper exercise of federal power because it impermissibly interferes with the State's management of its fiscal system and its provision of benefits to State employees.

2. Whether the decision of the Tenth Circuit Court of Appeals conflicts impermissibly with a decision of the United States Supreme Court with respect to the effect of purely private decision making on the character of governmental funds.

3. Whether the decision of the Tenth Circuit Court of Appeals conflicts with a decision of the United States Supreme Court concerning the construction of federal grants to fund state programs.

PARTIES TO THE PROCEEDING

The parties to the appeal before the Tenth Circuit Court of Appeals were the State of Oklahoma, ex rel. The Office of State Finance, plaintiff before the United States District Court for the Western District of Oklahoma, appellant before the Tenth Circuit Court of Appeals, and petitioner herein, and Tommy G. Thompson, Secretary of Health and Human Services *ex rel.* Department of Health and Human Services and United States of America, defendants in the United States District Court for the Western District of Oklahoma, appellees before the Tenth Circuit Court of Appeals and respondents herein.

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PETITION FOR A WRIT OF CERTIORARI

The State of Oklahoma *ex rel.* Office of State Finance respectfully petitions for a writ of certiorari to review the judgment of the United States Court of Appeals for the Tenth Circuit.

OPINIONS BELOW

The opinion of the court of appeals (Pet. App. 1) is reported 292 F.3d 1261. The order denying rehearing en banc and panel rehearing (Pet. App. 9) is unreported. The opinion of the district court (Pet. App. 11) is unreported. The opinion of the Departmental Appeals Board (Pet. App. 17).

JURISDICTION

The judgment of the court of appeals was entered on June 12, 2002, and rehearing was denied on August 12, 2002 (Pet. App. 9). This Court's jurisdiction rests on 28 U.S.C.A. § 1254(1).

CONSTITUTIONAL, STATUTORY AND REGULATORY PROVISIONS INVOLVED

Pertinent provisions of Section 1301 of Title 31 of the United States Code (Pet. App. 34); Section 1301 et. seq. of Title 74 of the Oklahoma Statute, the Oklahoma State and Education Employees Group Insurance Board (Pet. App. 35); Section 1361 et. seq. of Title 74 of the Oklahoma Statute, the Oklahoma State Employees Benefits Act (Pet. App. 38); and Office of Management and Budget Circular A-87 (Pet. App. 47) are set forth in an appendix to this brief.

STATEMENT OF THE CASE

Overview of State Reimbursement for Federal Programs.

Like all other states, Oklahoma administers numerous federal programs. The administration of these federal programs is enormously expensive for states, who typically utilize state employees to manage these programs. Appropriately, states are entitled to reimbursement for all costs that are attributable to federal work. The allowability of costs claimed by a state is governed by Office of Management and Budget Circular A-87 ("OMB A-87").

OMB A-87 dictates that to be allowable under a federal award, costs must be necessary and reasonable for proper and efficient performance and administration of federal awards and must be "allocable" to those federal awards in accordance with the relative benefits received. OMB A-87, paragraph C.3.a., p. 88. Specifically, OMB A-87 provides that employee compensation, including fringe benefits, paid to employees who work on federally funded programs are allowable costs so long as it meets the basic requirements affecting the allowability of costs. OMB A-87, paragraph 11.a., p. 95. Allowable fringe benefits include employee life, health, unemployment, and workers' compensation insurance. OMB A-87, paragraph 11.d.5, p. 95.

An allowable cost is allocable to a particular cost objective if "the goods or services involved are chargeable or assignable to such cost objective in accordance with relative benefits received." OMB A-87, paragraph C.3.a., p. 88. In this instance, the relevant costs to further the federal purpose are the fringe benefits paid to those state employees working on federal programs. Here, there is no dispute that all state

employees working on federal programs received the fringe benefits to which they were entitled.

The Oklahoma Flexible Benefit Statute

The Oklahoma State Employees Benefits Act ("Employees Benefits Act") was enacted to furnish State employees and their dependents with choices in health, life, disability, and other insurance benefits. *See* Title 74 O.S. § 1362(1) - (5). Under the Employee Benefits Act, employees of the State of Oklahoma, as part of their compensation, are paid a flexible benefit allowance ("Benefit Allowance"), an amount specified by statute. *See*, 74 O.S. § 1370. Once a Benefit Allowance is paid to a state employee, that individual has the ability to direct the funds to any enumerated allowable expense. *See* 74 O.S. § 1366(D). An employee may elect to purchase insurance benefits, contribute it to a retirement plan, or use it for the payment of dependent care. *See* 74 O.S. § 1366(D).

Should an employee desire to purchase insurance benefits, they have numerous options from which to choose. A state employee may direct all or part of their Benefit Allowance to any number of private health maintenance organizations ("HMOs") or to the insurance organization established by the State of Oklahoma, the Oklahoma State and Education Employees Group Insurance Board ("OSEEGIB"). 74 O.S. § 1304. Should a participating employee desire to purchase from a menu of benefits whose sum total of premiums exceeds the Benefit Allowance, the employee can elect to purchase the excess benefits with "pay conversion dollars" deducted from the employee's salary. 74 O.S. § 1370(E). On the other hand, where the Benefit Allowance exceeds the cost of benefits selected and purchased by the

employee, the employee receives the excess Benefit Allowance as additional taxable compensation. 74 O.S. § 1370(F).

The Oklahoma Insurance Plan

The State of Oklahoma created OSEEGIB to provide health, life, disability and other insurance benefits to employees of the State of Oklahoma, employees of local governmental entities and school districts, and various other eligible groups. 74 O.S. § 1301.

State employees electing to purchase insurance benefits through OSEEGIB, or any other HMO, are required to make their election known to their specific state agency employer. The state agency, on behalf of the state employee then withholds the designated amount from the employee's compensation and transmits the employee's premium to the appropriate insurance provider. When an employee selects coverage through OSEEGIB, the state agency transmits the employee paid premiums to the OSEEGIB Reserve Fund ("Reserve Fund"), which is used for administration of the state's plan and the payment of benefits to those participating employees.

In 1996, the Oklahoma Legislature enacted legislation requiring state agencies to transmit a certain amount of the employee paid premiums designated for the purchase of coverage from OSEEGIB to both the Reserve Fund and to the State Employees Group Insurance Clearing Fund ("Clearing Fund"). *See* 74 O.S. § 1310. The Legislature then directed the first $31.5 Million paid to the Clearing Fund to be distributed to the Oklahoma State Regents for Higher Education ("Regents"). The remaining balance was to be deposited into the Reserve Fund. *See* 74 O.S. § 1312.3. These transfers were

accomplished according to legislative mandate. More importantly, the employees who elected to use the Benefit Allowance to purchase insurance from the state's plan received all coverage purchased.

Disallowance by the Department of Health and Human Services

In a letter dated October 8, 1997, the Department of Health and Human Services of the United States of America ("HHS") disallowed the transfer on two grounds. First, HHS claimed the amounts the state agencies paid into the Clearing Fund were not necessary and reasonable for the provision of health insurance for state employees working on federal programs, did not benefit and were not allocable to the federal programs, and thus were not allowable under OMB A-87. Second, HHS claimed the transfer to the Clearing Fund violated specific language in OMB A-87 requiring that "[w]henever funds are transferred from a self-insurance reserve to other accounts (e.g., general fund), refunds shall be made to the Federal Government for its share of funds transferred, including earned or imputed interest from the date of transfer." OMB A-87, Attachment B, paragraph 25.c.5. HHS then demanded refund of the transfers.

Oklahoma's Response

In response to the disallowance and demand for refund by HHS, Oklahoma appealed to the Departmental Appeals Board of HHS ("DAB") claiming that the federal government did in fact receive what it paid for, namely health insurance benefits for all employees working on federal programs. In support, Oklahoma noted that all participants in the OSEEGIB plan continued to receive all of their health insurance benefits.

Affirming the disallowance in DAB Op. No. 1668, the DAB ordered the amount transferred to the Regents be returned to the federal government. The DAB reasoned Oklahoma had violated a basic principle of federal appropriations law, which requires federal funds to be used for the purposes for which they were awarded, because the funds allocated for the provision of health insurance for state employees working on federal programs were instead transferred to the Regents. DAB Op. No. 1668, p. 4.

Oklahoma's Further Appeal

Oklahoma then took their appeal to the United States District Court for the Western District of Oklahoma. Affirming DAB Decision No. 1668, the district court reasoned only that the findings by the DAB were not "arbitrary or capricious, nor an abuse of discretion." *State of Oklahoma Office of Finance v. United States*, No. CIV-00-316-W (unpublished).

Undaunted, Oklahoma looked to the Tenth Circuit for vindication. This time, Oklahoma's argument was twofold. First, Oklahoma again reiterated that the federal government got the health insurance for which it paid as "the record is devoid of any evidence that any state employee failed to receive the full amount of healthcare benefits purchased." *State of Oklahoma Office of State Finance v. United States*, 292 F.3d 1261, 1263 (10th Cir. 2002). Second, upon questions from the Court, Oklahoma argued that once the Benefit Allowance is paid to a state employee, who then has the right to purchase insurance from a number of providers including OSEEGIB, the funds lose their federal character. Consequently, once the funds have lost their federal character, HHS "cannot contest Oklahoma's use of the contested funds for higher education

purposes." *Id.* at 1264. The State contends that once the Benefit Allowance has been paid to the employees how the state chooses to manage the premiums is beyond the reach of the federal government.

Inexplicably, the Tenth Circuit determined that it was unnecessary to consider the point at which federal funds lose their federal character. Affirming the district court and upholding a disallowance in the amount of $7,138,280.00, the Tenth Circuit held merely that "OMB A-87's definition of 'cost' excludes 'transfers to a general or similar fund.' Federal monies forwarded to Oklahoma's Clearing Fund represent unrecoverable 'transfers to a general or similar fund.'" *Id.* Therefore, "[t]he money diverted to the Clearing Fund fails to qualify as reimbursable cost in the first instance." *Id.* The Tenth Circuit thus held that the federal government can control how the State manages the premiums even after the federal purpose has been satisfied by the payment of compensation to the state employee who has performed work on behalf of the federal government. If the Tenth Circuit opinion stands, the State is required to return the grant to the federal government, then the federal government will have forced the state to implement federal programs at no cost to the federal government.

REASONS FOR GRANTING A WRIT OF CERTIORARI

I. This case presents an important question concerning the permissible reach of the federal government into state's sovereign affairs.

The federal regulation as applied by the Tenth Circuit Court of Appeals impermissibly interferes in matters traditionally left to states in the federal system. The Tenth Circuit's failure to address the issue of when federal grants lose their federal character resulted in a violation of the sovereignty of the State of Oklahoma, because it allowed the federal government to dictate how the State managed its funds even after the State satisfied the objectives of the federal grant by compensating those state employees who performed federal work.

This Court has repeatedly recognized "the imperative need of a State to administer its own fiscal operations." *Franchise Tax Bd. of California v. Alcan Aluminum Ltd.*, 493 U.S. 331, 338, (1990) (examining the legislative history of the Tax Injunction Act, 28 U.S.C. § 1341). *See also, Roswell v. LaSalle Nat. Bank*, 450 U.S. 503, 522, (1981) and *Tully v. Griffin, Inc.*, 429 U.S. 68, 73, (1976). Further, this Court has announced "[w]hen dealing with their proper domestic concerns, and not trenching upon the prerogatives of the National Government or violating the guaranties of the Federal Constitution, the States have the attribute of sovereign powers in devising their fiscal systems to ensure revenue and foster their local interest." *Lehnhausen v. Lake Shore Auto Parts Co.*, 410 U.S. 356, 359, (1973) (citing *Allied Stores of Ohio, Inc. v. Bowers*, 358 U.S. 522, 526 - 527, (1959)).

This Court has consistently held that statutes must be interpreted to protect State functions from federal regulation, absent a clear statement of congressional intent to so intrude. *Gregory v. Ascroft*, 501 U.S. 452, 457, 460-65 (1991). Thus, if a contract between a State and the Federal government by its terms would intrude upon State sovereignty, it will still pass constitutional muster if the State may elect to forego the receipt of federal funds to preserve its control over sovereign functions. *New York v. United States*, 505 U.S. 144, 158-160 (1992). In contrast, a restriction on state sovereignty implied with the contract after it is entered into is an impermissible intrusion because, if the federal regulation does not clearly set out how it will impact state sovereign functions, then the state cannot make an informed decision whether to accept the federal grant in exchange for relinquishment of some portion of its sovereignty. Implied restrictions which are unknown, and thus involuntarily accepted by States, allow the federal government to regulate States in ways not outside the constitutionally allocated powers.

The federal regulation at issue here, OMB A-87, is unconstitutional as applied by the Tenth Circuit.

1. Application of OMB A-87 to the Employees Benefits Act.

The funds in question relate to amounts that federal agencies paid as the federal share of costs incurred by state during state fiscal year 1997 ("SFY 1997") for fringe benefits paid by the state agencies to employees who worked on federal programs funded by federal grants. The allowability of costs claimed by state governments under federal grant programs is governed by OMB A-87, which provides that fringe benefit allowances are recoverable costs if necessary

and reasonable for the proper and efficient administration of the federal awards and allocable to those federal awards in accordance with the relative benefits received. OMB A-87, paragraph C.3a., p. 88; OMB A-87, paragraph 11.d.5, p. 95.

Here, the federal government reimburses the State of Oklahoma for the fringe benefit costs paid to employees under the Employees Benefits Act. Each State employee, as part of his or her compensation, is paid or "credited" with a specified amount, set by statute, as a flexible Benefit Allowance available for the purchase of the available benefits of choice. Title 74 O.S. §§ 1363(12) and 1370(B). The pivotal word is "choice," because once the Benefit Allowance has been allocated to an employee, that employee retains control over how to direct, or spend, the allowance. The employee's choice directs all or part of his or her Benefit Allowance for the purchase of insurance benefits from either a private HMO or from OSEEGIB, the State's insurance plan. Title 74 O.S. § 1366. If the participating employee desires to purchase benefits with premiums exceeding the Benefit Allowance, the employee can elect to use pay conversion dollars, in the form of salary reduction, to purchase the excess benefits. Title 74 O.S. §§ 1370 (F), 1363(16). If the Benefit Allowance exceeds the cost of benefits selected and purchased by the employee, the employee receives the excess Benefit Allowance as additional taxable compensation, which the employee is then free to spend however he chooses. Title 74 O.S. § 1370 (G). Once the compensation is paid to the employee it is beyond the reach of the federal government.

OMB A-87, and the federal costing principles, were never intended to regulate funds that have already passed through the pockets of the employees who received the fringe benefits from the State as compensation. Post-compensation

transfers of employee premiums, having entered the insurance marketplace from the employees hands as private moneys, do not fall under the OMB A-87's definition of costs, and are thus beyond the reach of the federal government.

2. OMB A-87 Does Not Apply to the Federal Funds after the Employee has been Compensated.

If the funds have indeed lost their federal character, OMB A-87 no longer applies. The Tenth Circuit's explicit refusal to decide whether the funds are subject to OMB A-87 resulted in the unconstitutional intrusion of the federal government into sovereign state functions. The Court of Appeals used the definitional section of OMB A-87, a federal regulation, to decide that it was unnecessary to decide whether the regulation applied. If the funds are not subject to OMB A-87 then OMB A-87 cannot be applied.

The funds at issue had lost their federal character and OMB A-87 should not have been applied against the State. When the State paid the Benefit Allowance to the employee, the obligation of the State to pay the employee fringe benefits was satisfied, and the linkage between the cost objective (payment of fringe benefit costs of those employees allocated to the federal program) to the benefits received by the federal government was complete. It is at *this* point that OMB A-87 should have been applied to ascertain whether the compensation was reimbursable from federal funds. If the State's compensation program as of this point met the requirements of OMB A-87 then the federal government was obligated to reimburse the State for the cost of those federal programs. The subsequent payment from the employee to the insurer is beyond the reach of the federal government. What

the insurer, whether the State or a private HMO, does with its premium dollars is also a decision beyond the reach of the federal government.

The hallmark trait of the State of Oklahoma's provision of health benefits compensation to its employees is private choice. Once the employee receives as part of payroll the Benefit Allowance for the employee's choice of health coverage, any funds attributable to federal programs lose all state or federal color as they become the *employee's funds* to purchase health insurance coverage. The employee's private choice then directs his or her funds toward a particular provider. But *before* that private choice is made, the costs of the federal program administered by the State have been paid, and the cost objectives of the federal program have been met. The federal funds paid to the State have been used for federal purposes: the payment of the Benefit Allowance to the State employee in order for the state employee to purchase insurance coverage. The federal government is reimbursing the State of Oklahoma the Benefit Allowance paid to the state employee who worked on the federal program. How the funds paid by the *employee* for insurance coverage are subsequently managed by the State is immaterial. The private choice of an individual recipient cannot dictate whether the funds comply with federal law.[1]

[1] The federal reimbursable funds lose their federal character once the Benefit Allowance is paid, or "credited" to each state employee. At that point, the employee chooses to pay for the level of coverage or benefits as the employee sees fit.

3. The State's Contract With the Federal Government Must be Construed Under its Terms.

As this Court recently reiterated in *Barnes v. Gorman*, 122 S.Ct. 2097 (2002), a grant of federal funds is a contract. If Congress intends to impose a condition on the grant of federal monies, the condition must be unambiguous. A state cannot be held limited by conditions it did not accept as part of the contract. *Gorman*, 122 S.Ct. 2097, 2100-01.

As the Tenth Circuit correctly recognized, the contract between the federal government and the State of Oklahoma provides that "[e]mployee compensation and fringe benefits are specifically included as permissible costs entitled to reimbursement from the federal government." Opinion P. 5, citing Aplt. App. at 94-95. Here, the State of Oklahoma provided employee compensation and fringe benefits to its employees working on federal programs. Opinion, p.2. Once the State provided to its employees compensation and fringe benefits for working on the federal programs, those payments became "permissible costs entitled to reimbursement from the federal government," and the State of Oklahoma was entitled to reimbursement. What the individual employee *later* did with respect to allocation of the compensation is completely irrelevant to the contract between the federal government and the State. The State cannot be bound by a condition not included in the contract.

The federal government contracts with the State of Oklahoma to reimburse a portion of the reasonable and necessary employee expenses for the state's administration of federal projects. Oklahoma State law sets, as one of these employee expenses, a Benefit Allowance to be provided to

each State employee. OMB A-87 does allow for such costs as reimbursable expenses. OMB A-87, paragraphh (11)(d)(1), p. 94-95.

Under this contract, the State has met its obligation to the federal government once the Benefit Allowance is paid to the employee for the employee's choice of health coverage. Once the Benefit Allowance is paid, the State's contractual obligation to the federal government is satisfied. Plainly, after the compensation is paid to the employee, it belongs to the employee, and whether he spends it on video games, makes a contribution to his place of worship, or purchases health insurance, regulation of those expenditures is beyond the reach of the federal government's contract with the State.

The Tenth Circuit reads a limitation that is otherwise not expressed into the State's contract with the federal government, in violation of federal common law. The opinion, in effect, revises the contract to include the condition that federal scrutiny attaches permanently to the health care insurance choices made by those State employees who choose to purchase their health care benefits from OSEEGIB. The federal government will not scrutinize the post-compensation conduct of health insurance providers other than OSEEGIB, such as HMOs. The record reflects that HHS has never sought reimbursement from or otherwise tried to exert power over the benefit allowances that state employees direct to private HMOs, whether reserves are high or low or whether more or less profits are taken out by the companies. But when part of the same benefit allowances are directed by the employees to be paid to a state enterprise, here, OSEEGIB, and the State chooses to raise or lower reserves, under the opinion below the same employee-directed funds suddenly became funds subject to federal control. This interpretation of the contract is

inconsistent with its terms, and the State cannot be bound by limitations it did not accept. *Barnes v. Gorman*, 122 S.Ct. 2097, 2010-01 (2002)

This same issue was correctly interpreted by the Second Circuit in the ERISA context, by rejecting the Plaintiffs' challenge to a premium pooling arrangement. The Plaintiffs alleged the pooling arrangement violated the plan managers federally imposed fiduciary duties: the employee benefits funds were diverted under the pooling arrangement for the use of non-plan participants. *See NYS H.M.O. Conference v. Curiale*, 64 F.3d 794, 799 (2nd Cir. 1995). The Second Circuit agreed with the defendants that "when employee benefit plans make payments to an HMO those funds are not segregated for the exclusive use of plan participants; rather the HMO may use those funds in its everyday operations to benefit all of its consumers...there exists no appreciable difference between the use of plan funds by the insurer's own non-ERISA subscriber pool and the use of such funds by the larger....pool. In both cases, the plan administrator's fiduciary duty is realized when she submits the required payments to the insurer pursuant to the benefits contract." *Id.* at 799, fn. 13.

Here as well, the federal funds in question were used for precisely the purpose for which they were awarded: to reimburse the State for the fringe benefits paid to the employees who worked on federal programs. The State of Oklahoma complied with the contract and should be allowed to retain the federal funds.

II. The decision of the Tenth Circuit conflicts impermissibly with this Court's jurisprudence concerning the effect of purely private decision making on the character of governmental funds.

On June 27, 2002, this Court decided the same issue at stake here in *Zelman v. Simmons-Harris*, 122 S.Ct. 2460 (2002), a case involving the constitutionality of the Cleveland Ohio school voucher program. In *Zelman*, this Court declared that the use of government funds in the form of school vouchers, directed by individuals for religious purposes, did not violate the Establishment Clause. *Zelman v. Simmons-Harris*, 122 S.Ct. 2460, 2467-68 (2002). The decision relied on a long line of established precedents. *See, Mitchell v. Helms*, 530 U.S. 793 (2000); *Witters v. Washington Dept. of Services for the Blind*, 474 U.S. 481 (1986); and *Mueller v. Allen*, 463 U.S. 388 (1983). While *Zelman* involved the Establishment Clause, the issue presented therein is, at its core, identical to that here: at what point do government funds paid to private individuals, who have complete discretion over the use of the funds, lose their federal character?

In *Mueller*, this Court examined whether a state program which allowed tax deductions for various educational expenses, including private school tuition costs, violated the Establishment Clause because a majority of the beneficiaries were parents of children attending parochial schools. *Mueller*, 463 U.S. at 391. In holding that the Establishment Clause was not offended, this Court emphasized the principle of private choice. "Under [the State's] arrangement, public funds become available only as a result of numerous, private choices of individual parents of school-age children." *Id.* at 399. This Court reasoned that because the government dollars reach parochial schools only due to the genuine and independent choices of private individuals, the allocation of funds was not attributable to the government. *Id.*

In *Witters*, this Court considered whether a state funded vocational rehabilitation program violated the Establishment Clause because a potential recipient wanted to use state funds to support his religious education. *Witters*, 474 U.S. at 488. Failing to find a constitutional violation, this Court reasoned, "any aid provided under [the State's] program that ultimately flows to religious institutions does so only as a result of the genuinely independent and private choices of aid recipients." Moreover, "the fact that aid goes to individuals means that the decision to support religious education is made by the individual, not by the State." *Id.* This Court further posited that "a State may issue a paycheck to one of its employees, who may then donate all or part of that paycheck to a religious institution, all without constitutional barrier; and the State may do so even knowing that the employee so intends to dispose of his salary." *Id.* at 486-487. Thus, this Court again recognized that once government funds are put in the hands of a private individual who has complete control over the use of those funds, those funds lose their public characteristic.

Similarly, in *Mitchell*, this Court reviewed a challenge to a federal program that directed federal funds to local educational agencies in order to implement programs to assist children in elementary and secondary schools. *Mitchell*, 530 U.S. at 802. The local educational agencies would use the federal funds to lend educational equipment to both public and private schools. *Id.* at 801. A majority of the private school beneficiaries were religiously affiliated leading to a constitutional challenge. *Id.* This Court reasoned "if aid to schools, even direct aid, is neutrally available and, before reaching or benefiting any religious school, first passes through the hands (literally or figuratively) of numerous private citizens who are free to direct the aid elsewhere, the

government has not provided any support of religion." *Id.* at 816 (citations omitted). Once again, this Court declared that federal funds that are neutrally available lose their federal character once they pass through the hands of a private individual who is free to "direct the aid elsewhere." *Id.*

Finally, in *Zelman*, this Court upheld a state voucher program that gave tuition aid to parents residing in covered school districts. *Zelman*, 122 S.Ct. at 2463. Parents were free to use the state aid at a qualified school of their choosing whether or not the school was religiously affiliated. This Court reiterated that when a government pays money under a neutral scheme, the government's role *"ends with the disbursement of benefits."* *Id.* at 2467 (emphasis supplied). The Court reasoned that government funds may be used to support state run programs, even if the funds are used to support a purpose the government cannot directly support, so long as the state run program distributes the money neutrally to its beneficiaries. *Id. The private choice of the beneficiaries breaks the connection to the government, and the funds cease to be government funds. Id.* Citing *Mueller, supra*, this Court found irrelevant the purpose to which an individual ultimately directed the funds because the neutrality of the program ensured that the individual's private choice will break "the circuit" between government and an otherwise prohibited governmental expenditure. This Court recognized that any other outcome would be irrational: "We would be loath to adopt a rule grounding the constitutionality of a facially neutral law on annual reports reciting the extent to which various classes of private citizens claimed benefits under the law." *Id.* at 2466 (quoting *Mueller*, 463 U.S. at 401).

Interpreting these principles under similar facts, the Fifth Circuit has set forth a test for determining when federal

funds lose their federal character. *United States v. Long*, 996 F.2d 731 (5th Cir. 1993). *See also, United States v. McIntosh*, 655 F.2d 80 (5th Cir. 1981) and *United States v. Hope*, 901 F.2d 1013 (11th Cir. 1993) (applying supervision and control test to a conviction under 11 U.S.C.A. § 641). The test examines the control exercised by the federal government over the ultimate disposition of funds. "The critical factor in determining the sufficiency of the federal interest is the basic philosophy of ownership reflected in the relevant statutes and regulations.... The key factor involved in this determination of federal interest is the *supervision and control* contemplated and manifested on the parts of the government." *Long*, 996 F.2d at 732 (emphasis supplied).

In *Long*, the Fifth Circuit held that under 18 U.S.C.A. § 641, funds received and held by a state agency retain their federal character because at that point, there is no indication that Congress intended to "relinquish control over the federal purse strings." *Long*, 996 F.2d at 733. However, the Fifth Circuit has also noted that "we may accept the argument that when an outright grant is paid over to the end recipient...the money in the grant ceases to be federal." *McIntosh*, 655 F.2d at 84.

Here, the Tenth Circuit's decision controverts the decisions in *Meuller, Witters, Mitchell,* and *Zelman*. The Tenth Circuit failed to recognize that determining at what point the funds lost their federal character (and thus whether the funds post-compensation application is subject to federal law) was a *necessary prerequisite* to applying federal law to individual choices made with respect to the funds. Only if the funds still retained their federal character *after* the individual choices of the State employees can federal law be applied to the funds.

Looking at the State of Oklahoma's benefit program from the front end, it complies with OMB A-87 in all respects. The fringe benefits were provided neutrally and evenhandedly to all State employees performing work for the federal government. Those employees were provided an array of benefit providers to which they could allocate their benefit dollars. This is the point at which the program must be analyzed for its compliance of OMB A-87. Analyzed there, the program beyond challenge fully satisfies the directive. Once the aid recipients' private choices direct allocation of the funds to different offerings in the benefit array, the "circuit is broken" and the funds cease to maintain their federal character. The private choices of the employees cannot be imputed to the government neutrally disbursing the funds. As this Court emphasized in *Zelman*, any other outcome would be absurd because it would allow the aid recipients' *private* choices to dictate the legality of expenditures made under a *facially neutral* law. *See Zelman*, 122 S.Ct. at 2466.

III. The opinion of the Tenth Circuit conflicts with a decision of this Court concerning the construction of federal grants to fund state programs.

In *Barnes v. Gorman*, 122 S.Ct. 2097 (2002), this Court reversed a decision of the Eighth Circuit Court of Appeals which had held that punitive damages may be awarded against a municipal government in a private cause of action brought under federal law. In so doing, this Court reiterated the fundamental rule that a grant of federal funds to a state is a contract, and only those terms unambiguously expressed in that contract are binding against the state. *Gorman*, 122 S.Ct. at 2100-2101, quoting *Pennhurst State School & Hospital v. Halderman*, 451 U.S. 1, 17 (1981) ("if Congress intends to impose a condition on the grant of federal moneys, it must do so unambiguously."). In *Barnes*, the grant of federal funds did

not expressly provide that states would be subject to punitive damages for violating the pertinent federal statue, thus the state could not be subject to punitive damage awards. *Barnes*, 122 S.Ct. at 2102-2103. That same fundamental rule was misapprehended by the Tenth Circuit decision here. The terms of the contract between the State of Oklahoma and HHS are to be found within the four corners of OMB A-87. Nowhere in OMB A-87 does it say that the *private choices* made by state employees *post-compensation* would be governed by OMB A-87. The Tenth Circuit read implied terms into the contract with the state, in violation of the principle reaffirmed by this Court in *Barnes*.

CONCLUSION

For the reasons set forth above, the petition should be granted.

Respectfully submitted,

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APPENDIX

APPENDIX 1

OPINION OF THE COURT OF APPEALS

UNITED STATES COURT OF APPEALS FOR THE TENTH CIRCUIT

OFFICE OF STATE FINANCE, STATE OF OKLAHOMA, EX REL., Plaintiff-Appellant,	
v.	**CIV-00-316-W No. 01-6291**
UNITED STATES OF AMERICA; TOMMY G. THOMPSON, Secretary of Health and Human Services, ex rel. Department of Health and Human Services, Defendants-Appellees	

JUDGMENT

Filed June 12, 2002

Before LUCERO, McKAY, and MURPHY, Circuit Judges

This case originated in the Western District of Oklahoma and was argued by counsel.

The judgment of that court is affirmed.

Entered for the Court
PATRICK FISHER, Clerk

By: Deputy Clark

APPENDIX 2

UNITED STATES COURT OF APPEALS
FOR THE TENTH CIRCUIT

OFFICE OF STATE FINANCE, STATE OF OKLAHOAM, EX REL., **Plaintiff-Appellant,** **v.** **UNITED STATES OF AMERICA; TOMMY G. THOMPSON, Secretary of Health and Human Services, ex rel. Department of Health and Human Services,** **Defendants-Appellees**	**CIV-00-316-W** **No. 01-6291**

APPEAL FROM THE UNITED STATES DISTRICT COURT FOR THE WESTERN DISTRICT OF OKLAHOMA
(D.C. NO. 00-CV-316-W)

Marc Edwards (William S. Price, Robert N. Sheets, and Scott E. Williams with him on the briefs) of Phillips McFall McCaffrey McVay & Murrah, P.C., Oklahoma City, Oklahoma, for Plaintiff-Appellant.

Christine N. Kohn, Attorney, Appellate Staff (Robert D. McCallum, Jr., Assistant Attorney General, and Barbara

APPENDIX 3

C. Biddle, Attorney, Appellate Staff, Civil Division, Department of Justice, Washington D.C.; and Robert G. McCampbell, United States Attorney, Oklahoma City, Oklahoma , with her on the brief), for Defendants-Appellees.

Before **LUCERO, McKAY,** and **MURPHY,** Circuit Judges

McKAY, Circuit Judge.

Oklahoma appeals the Western District of Oklahoma's final order and judgment upholding a decision issued by the Departmental Appeals Board (DAB) of the United States Department of Health and Human Services (HHS). The DAB decision upheld the HHS' disallowance of $7,426,672 of federal funds paid to the state.

I. Background

Oklahoma employs several state workers whose duties include the administration of various federal programs. Oklahoma and its various state agencies are entitled to reimbursement for the federal government's proportionate share of salaries and fringe benefits attributable to federal work being performed by state employees as long as the costs of implementing federal programs are legitimate, necessary, and allowable. Because an understanding of the underlying facts is essential for the proper disposition of this appeal, we provide a brief overview of the Oklahoma State Employees Benefits Act (Benefits Act), the Oklahoma State and Education Employees Group Insurance Board

(OSEEGIB), the Office of Management and Budget Circular A-87 (OMB A-87), and the procedural history of this case.

Oklahoma's Benefit Act provides for a benefit allowance to be paid to state employees. The amount of the benefit allowance is set by statute. State employees use the benefit allowance to purchase a variety of insurance benefits including health, life, and disability. Employees select the amount, types of coverages, and providers they prefer. If an employee selects a level of coverage with a price in excess of the benefit allowance, the employee is charged the difference. Conversely, if an employee selects coverage costing less than the benefit allowance, the unspent amount is forwarded to the employee as gross income.

With respect to health care coverage, employees have three basic choices. Employees can choose to receive unused portions of the benefit allowance as gross income, secure insurance from a number of private health care providers, or elect to be insured by OSEEGIB. The State then forwards the appropriate monies to the various providers as directed by the employee. OSEEGIB is a creation of Oklahoma statute. Basically, OSEEGIB is a state- run, self-insured provider of healthcare benefits. State employees are just one group of employees eligible for coverage through OSEEGIB. Employees of school districts, local governmental entities, and other groups are also eligible for health care coverage with OSEEGIB. OSEEGIB competes with various private insurers as a potential recipient of benefit allowance monies. Premiums from employees that elect OSEEGIB as their healthcare provider are deposited into the OSEEGIB reserve fund. This reserve fund pays for

medical claims and the expenses of administering OSEEGIB.

In 1996, Oklahoma passed 74 O.S. § 1310 directing state agencies to forward premiums usually sent to OSEEGIB's reserve fund to the State Employees Group Insurance Clearing Fund. The legislature further directed that the first $31.5 million paid into the Clearing Fund was to be distributed to the Oklahoma State Regents for Higher Education. Monies received after the initial $31.5 million were to be deposited into the Reserve Fund. Oklahoma concedes that the $31.5 million which normally would have been deposited into the Reserve Fund was diverted to the Clearing Fund as mandated by statute. These funds were then used for purposes of higher education rather than for healthcare expenditures.

OMB A-87 sets forth the parameters governing a state's entitlement to federal reimbursement for the state's costs of implementing federal programs. It defines "cost" as "an amount as determined on a cash, accrual, or other basis acceptable to the Federal awarding or cognizant agency. It does not include transfers to a general or similar fund." Aplt. App. at 86. Costs must also be necessary and reasonable, allocable to federal awards, and be accorded consistent treatment and adequately documented. *See id.* at 87-88. Employee compensation and fringe benefits are specifically included as permissible costs entitled to reimbursement from the federal government. *See id.* at 94-95.

HHS, by letter, announced that it was disallowing all Oklahoma State agency claims for reimbursements related to OSEEGIB contributions paid into the Clearing Fund. Ultimately, HHS disallowed $7,138,280 of federal

funds previously paid to the State. Oklahoma appealed this decision to the DAB. DAB upheld the disallowance, ruling that the monies had been awarded for insurance premiums but had been spent for other purposes. The DAB determined that Oklahoma's conduct violated the principle that federal funds must be applied to the objective for which the appropriations were made--in this case, health insurance. Oklahoma challenged DAB decision number 1668 in the United States District Court for the Western District of Oklahoma. The district court upheld the DAB's decision. Oklahoma appeals to this court.

II. Standard of Review

At issue in this case is whether Oklahoma's diversion of funds from OSEEGIB's Reserve Fund to the Clearing Fund to be used for purposes of higher education violates OMB A-87's mandate concerning state reimbursement for costs incurred in administering federal programs. We review pursuant to the provisions of the Administrative Procedures Act. We must uphold the district court's affirmance of final agency action unless the agency's decision was "arbitrary, capricious, an abuse of discretion, or otherwise not in accordance with law." 5 U.S.C. § 706(2)(A) (1996). We may reverse the district court's decision if "unsupported by substantial evidence...." *Id.* at § 706(2)(E). When the decision involves the interpretation of an agency's own regulations, the agency's interpretation is given "substantial deference." *Thomas Jefferson University v. Shalala*, 512 U.S. 504, 512, 114 S.Ct. 2381, 129 L.Ed.2d 405 (1994).

III. Analysis

APPENDIX 7

We note that HHS is not arguing that the amount that it has reimbursed Oklahoma for healthcare benefits is unreasonable. Neither is HHS challenging any payments made directly to State employees or payments made to private healthcare providers. HHS only challenges payments for OSEEGIB benefits diverted from OSEEGIB's Reserve Fund to the Clearing Fund. Oklahoma argues that HHS got exactly what it bargained for because the record is devoid of any evidence that any State employee failed to receive the full amount of healthcare benefits purchased. All claims have been paid. Furthermore, because HHS is not contending that the actual amount paid for the healthcare benefits is unreasonable, Oklahoma argues that HHS may not contest the method in which Oklahoma handled OSEEGIB's premiums. Oklahoma further argues that once the benefit allowance is given to the employee, all funds lose their federal character. Because the funds have lost their federal character, HHS cannot contest Oklahoma's use of the contested funds for higher education purposes.

HHS insists that because OSEEGIB is a self-insurer run by the State the funds do not lose their federal character until the funds have been spent for healthcare related purposes (by paying claims or OSEEGIB's administration expenses). The Agency argues that the diversion of funds from OSEEGIB's reserves will lead to higher premiums and ultimately to increased costs Oklahoma will attempt to recover from HHS. Furthermore, the use of funds for higher education purposes violates the basic principle envisioned by OMB A-87 that federal funds must be applied to the objective for which the appropriations were made.

APPENDIX 8

While determining the point at which federal funds cease to be federal funds is an intriguing issue, the resolution of that issue is unnecessary for the disposition of this appeal. The correct answer is much more simple. OMB A- 87's definition of "cost" is singularly fatal to Oklahoma's appeal.

OMB A-87's definition of "cost" excludes "transfers to a general or similar fund." Aplt. App. at 86. Federal monies forwarded to Oklahoma's Clearing Fund represent unrecoverable "transfers to a general or similar fund." Thus, there is no need to ascertain when federal money loses its federal nature, or even if the monies Oklahoma is attempting to be reimbursed for are necessary and reasonable expenditures. The money diverted to the Clearing Fund fails to qualify as a reimbursable cost in the first instance. Although the district court did not cite OMB A-87's definition of cost as a basis for its decision, it is well established that "[w]e are free to affirm a district court decision on any grounds for which there is a record sufficient to permit conclusions of law, even grounds not relied upon by the district court." *United States v. Sandoval*, 29 F.3d 537, 542 n. 6 (10th Cir.1994) (quotations omitted).

The district court's decision was not arbitrary, capricious, an abuse of discretion, or not in accordance with the law. Furthermore, the district court's decision is supported by substantial evidence. Therefore, we affirm the district court's decision in all respects.

AFFIRMED.

APPENDIX 9

ORDER DENYING REHEARING

UNITED STATES COURT OF APPEALS

FOR THE TENTH CIRCUIT

OFFICE OF STATE FINANCE, STATE OF OKLAHOAM, EX REL, **Plaintiff-Appellant,** **v.** **UNITED STATES OF AMERICA; TOMMY G. THOMPSON, Secretary of Health and Human Services, ex rel. Department of Health and Human Services,** **Defendants-Appellees**	**CIV-00-316-W** **No. 01-6291**

Order
Filed August 12, 2002

Before **LUCERO, McKAY** and **MURPHY**, Circuit Judges

Appellant's petition for rehearing is denied.

The petition for rehearing en banc was transmitted to all of the judges of the court who are in regular active service as required by Fed. R. App. P. 35.

APPENDIX 10

As no member of the panel and no judge in regular active service on the court requested that the court be polled, the en banc petition is also denied.

Entered for the Court
PATRICK FISHER, Clerk of Court

by: /s/ A.J. Schuler
Deputy Clerk

APPENDIX 11

OPINION OF THE DISTRICT COURT

IN THE UNITED STATES DISTRICT COURT FOR THE WESTERN DISTRICT OF OKLAHOMA

STATE OF OKLAHOMA ex rel. OFFICE OF STATE FINANCE,	)	
Plaintiff,	)	No. CIV-OO-316-W
vs.	)	
DONNA SHALALA, SECRETARY OF HEALTH AND HUMAN SERVICES ex rel. DEPARTMENT OF HEALTH AND HUMAN SERVICES, and UNITED STATES OF AMERICA,	)	
Defendants.		

ORDER

This matter comes before the Court on the Motion to Dismiss filed by defendants Donna Shalala, Secretary of Health and Human Services ex rel. Department of

APPENDIX 12

Health and Human Services ("HHS'D, and United States of America pursuant to Rule 12(b)(1), F.R.Civ.P. Plaintiff State of Oklahoma ex ret. Office of State Finance ("State") has responded in opposition to the defendants' arguments that they are entitled to dismissal of Counts Four and Five of the amended complaint, and the defendants have replied.

The State has alleged in its amended complaint that the HHS "has disallowed, and now seeks to recover from the State... , over $7 million in federal matching funds the State . . .. is entitled to receive under several federal grant programs." Amended Complaint at 1-2, ¶ 1. The State has alleged further that it "appealed the disallowance to the HHS Departmental Appeals Board ("DAB")... [and that] DAB upheld the disallowance...." Id. at 5, ¶ 14.

The State has challenged the DAB's action under the Administrative Procedures Act ("APA"), 5 U.S.C. §

706, in Counts One, Two and Three. In Count Four, the State has alleged that "DAB's decision upholding the disallowance permits the federal government to be unjustly enriched." Id. at 9, ¶ 26. The State has contended in Count Five that "DAB's decision upheld the disallowance even after [the] State honored its contracts with its employees to provide salary and benefits and . . . its agreement to provide services as required by the grant contracts," *id.* ¶ 31, and has claimed in its prayer for relief, that the Court should therefore "[a]ward [the] State damages in a sum equivalent to the value of services performed, under the doctrine of quantum meruit." Id. at 10 ¶ F.

The United States is immune from suit except to the extent it consents to be sued. *E.g., Federal Deposit Insurance Corporation v. Meyer*, 510 U.S. 471 (1994). Because a suit against an executive department and/or against an officer in her official capacity is one against the

United States, it too is subject to the defense of sovereign immunity. *E.g., Hawaii v. Gordon*, 373 U.S. 57 (1963).

In the case-at-bar, the State has brought suit against the United States and a named individual in her official capacity. The lawsuit therefore may not be maintained unless the claims asserted by the State in its amended complaint fall within an express waiver of the federal government's sovereign immunity.

"[A) waiver of sovereign immunity is to be strictly construed, in terms of its scope, in favor of the sovereign." Department of the *Army v. Blue Fox, Inc.*, 525 U.S. 255, 261 (1999)(citations omitted). It is undisputed that Congress, by enacting the APA, has explicitly waived the sovereign immunity of the United States with respect to claims "seeking relief other than money damages." 5 U.S.C. § 702. Thus, judicial review of Counts One, Two and Three is available.

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The State has argued that judicial review of the allegations in Counts Four and Five is likewise permissible since the quasi-contract claims asserted in these counts are not in fact claims for money damages, but see Amended Complaint at 10, ¶ F, but rather are affirmative defenses to any recovery sought by the defendants in the administrative proceedings. As the party invoking this Court's jurisdiction, the State has the burden of identifying the appropriate statutory waiver of sovereign immunity and showing an express consent to suit. The Court finds the State has not met its burden despite the fact the State has characterized these claims as affirmative defenses. The State has advanced no case law or other authority that establishes that either the APA or any other statute has waived the federal government's sovereign immunity for those common law claims asserted by the State in Counts Four and Five of the amended complaint.

APPENDIX 16

Absent an unequivocal expression of waiver of sovereign immunity, the Court[1]

(1) GRANTS the defendants' Motion to Dismiss filed on October 10, 2000; and

(2) hereby DISMISSES Counts Four and Five in the State's amended complaint.

ENTERED this 28th day of November, 2000.

s/ Lee R. West
LEE R. WEST
UNITED STATES DISTRICT JUDGE

[1] Since the sole issue raised by the defendants' motion pertains to the Court's lack of jurisdiction over Counts Four and Five, the Court finds it unnecessary to consider the State's request that the Court strike portions of the defendants' brief because the brief allegedly contains matters not in the administrative record.

APPENDIX 17

DAB OPINION

Department of Health and Human Services

DEPARTMENTAL APPEALS BOARD

Appellate Division

SUBJECT: Oklahoma Office of State Finance
Docket No. A-98-9
Decision No. 1668

DATE: August 18, 1998

DECISION

The Oklahoma Office of State Finance (Oklahoma) appealed the decision of the Division of Cost Allocation (DCA) to disallow $7,715,064 in federal funds that Oklahoma received; under various federal programs, for a portion of the costs of group health insurance premiums paid on behalf on state employees. The disallowance consisted of $7,426,672 in federal funding provided for premiums, plus $288,392 in imputed interest. During the year ending June 30, 1997, the premiums were placed in a clearing fund within Oklahoma's insurance system, and the Oklahoma legislature removed the premiums from the clearing fund and used them for higher education expenses during that year. DCA took the disallowance on the basis that the health insurance costs charged to the federal programs in question did not in fact benefit the federal programs to which the costs had been charged, in violation of federal cost principles and other applicable authorities. DCA also cited cost principles requiring the refund of interest

imputed on federal funds that have been transferred out of a self-insurance reserve fund and used for other purposes.

Oklahoma did not dispute the basic facts, or DCA's calculation of the federal share of the premiums. Oklahoma argued that the transfer of the insurance premiums did not violate the cost principles and other applicable authorities, and that DCA was not permitted to recover imputed interest on the transferred funds.

The record in this appeal consists of the parties' written submissions and accompanying exhibits. As explained below, we sustain the disallowance of $7,426,672, representing federal funding transferred out of the group insurance system, because Oklahoma used those funds for purposes other than those for which the funds were awarded, in violation of the cost principles and other applicable authorities. We reverse the disallowance of $288,392 in interest that DCA imputed on the transferred funds, because we find that the provision in the cost principles permitting the recovery of imputed interest does not apply.[2]

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[2] DCA originally disallowed $20,828,150, which included the current disallowance amount, as well as the federal share of premiums transferred out of Oklahoma's group insurance system during the year ending June 30, 1992. DCA withdrew the disallowance for the earlier time period after Oklahoma filed its appeal, on the basis that this transfer was in effect a repayment, with interest, of an earlier transfer from the general revenue fund to the insurance system. DCA Brief (Br.), Attachment (Att.) E.

APPENDIX 19

Background

The Oklahoma State and Education Employees Group Insurance Board (OSEEGIB) provides health, life, disability and other insurance to employees of the state of Oklahoma, local governmental entities and school districts, and various other groups. Affidavit of Terry Hill, DCA Br.; Oklahoma State and Education Employees Group Insurance Act, Okla. Stat. tit. 74, § 1301 *et seq.* Insurance premiums paid by the employees and their employers, including employer contributions paid by Oklahoma on behalf of its state employees, are deposited into the appropriate OSEEGIB reserve fund, such as for health, dental, and life insurance, and are invested to generate income and used to pay claims and other related expenses. Okla. Stat. tit. 74, § 1312 (1995). To the extent that its employees work on federally funded programs, Oklahoma may receive federal reimbursement for a portion of its contributions to the OSEEGIB made on behalf of those employees; the amount of federal funding Oklahoma receives is based on the amount of its contributions.

Effective September 1996, the Oklahoma legislature amended the Oklahoma law governing the OSEEGIB, the State and Education Employees Group Insurance Act, to provide that Oklahoma state agencies, instead of paying premiums into the OSEEGTB reserves, would pay their employer contributions into a fund called the State Employees Group Insurance Clearing Fund (Clearing Fund). The amendment required that the first $31,500,000 received by the Clearing Fund during the year beginning July 1, 1996 (after the effective date of the act) would be distributed to the Oklahoma State Regents for Higher Education, with any funds remaining to be deposited in

the appropriate OSEEGIB reserve fund.[3] 1996 Okla. Sess. Laws Ch. 275, § 2; Okla. Stat. tit. 74, § 1312.3 (1998 electronic update). Oklahoma reported that it used the first $31.5 million in employer contributions for group health insurance premiums for state employees to fund needed expenditures in its system of higher education. Oklahoma reported that the transfer of funds was based on a perception that the OSEEGIB reserve funds were more than sufficient to cover anticipated claims. Oklahoma Br. 1. Oklahoma asserted that the underlying transaction was a transfer of accumulated OSEEGIB reserve funds, but that the payments were made instead with premium contributions because it was considered impractical to liquidate reserve investments.

Analysis

1. Oklahoma must refund federal funds awarded for OSEEGIIB premiums but transferred to higher education.

The allowability of costs claimed by state governments under federal grants is governed by Office of Management and Budget (OMB) Circular A-87. 45 C.F.R. §§ 74.27(a) and 92.22(b). A state's employer contributions

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[3] The Clearing Fund was created in 1991, apparently for the sole purpose of transferring state employer insurance contributions out of the OSEEGIIB. 1991 Okla. Sess. Laws Ch. 263. The law that created the Clearing Fund provided that the first $31,578,947.37 received during the year ending June 30, 1992 would be distributed to Oklahoma's general revenue fund, with the balance to be deposited into the appropriate OSEEGI7B reserve fund. Id., § 11.

to health insurance plans for employees who work on federally funded programs are generally allowable as employee fringe benefits, so long as they meet the basic requirements affecting allowability of costs set out in the OMB A-87.[4] A-87, Att. B, ¶ 11 .d(5).

OMB A-87 provides that, to be allowable charges to federal awards, costs must be necessary and reasonable for the proper and efficient administration of the federal awards and allocable to those federal awards. Att. A, ¶¶ C. 1 .a, b. The Circular further provides that-

> A cost is allocable to a particular cost objective if the goods or services involved are chargeable or assignable to such cost objective in accordance with relative benefits received.

Att. A, ¶C.3.a.

The federal government awarded the disallowed funds to pay a portion of Oklahoma's employer contributions for health insurance for its state employees, to the extent that those employees work on federally funded programs. Oklahoma would ordinarily have deposited the premiums into the OSEEGIB reserves, where they would have generated income and been used to pay health

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[4] OMB A-87 was revised in 1995. See 60 Fed. Reg. 26,484 (May 17, 1995). The revised version of OMB A-87 applies to cost allocation plans and indirect cost proposals submitted or prepared for a governmental unit's fiscal year that begins on or after September 1, 1995; and, for all other costs, to all awards or amendments, including continuation or renewal awards, made on or after September 1, 1995.

insurance claims and other related expenses. Okla. Stat. tit. 74, § 1312 (1995). Instead, Oklahoma removed the funds from its group insurance system and used them to pay the costs of higher education.

The higher education expenditures were not necessary and reasonable for the provision of health insurance for state employees working on federal programs, the purpose for which the funds were awarded. The higher education costs did not benefit and consequently were not allocable to those federal awards. The education costs were thus not allowable charges to federal awards under OMB A-87.

By using the federal funds for higher education expenses, Oklahoma also violated the basic principle of appropriations law that federal funds must be used for the purposes for which they were awarded.[5] Additionally, the various federal program statutes and regulations (and appropriation statutes) that authorize the use of federal funding for payment of administrative

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[5] 31 U.S.C. § 130 1(a) (former § 628) provides that federal appropriations shall be applied only to the objects for which the appropriations were made except as otherwise provided by law. "Simply stated, 31 U.S.C. § 1301(a) says that public funds may be used only for the purpose or purposes for which they were appropriated." *Principles of Federal Appropriations Law*, 2d ed., U.S. General Accounting Office, Office of the General Counsel, July 1991, OGC-91-5, at 4-2. As the Board has observed, Congress appropriates funds only for authorized purposes. A grantee's entitlement to federal funds does not extend beyond the federal financial participation (FFP) authorized in the grant statute. *New York State Dept. of Social Services*, DAB No. 1358 (1992). Grantees are not permitted to retain federal grant funds in excess of what is authorized and actually expended for program purposes. *Evangeline Community Action Agency*. Inc., DAB No. 1379 (1993); *Economic Opportunity Council of Suffolk. Inc.*, DAB No. 679 (1985).

costs require that the funding be used only for the authorized programmatic purpose. For example, the Medicaid program limits reimbursement for administrative costs under that program to amounts "found necessary by the Secretary for the proper and efficient administration of the State plan." Section 1 903(a)(7) of the Social Security Act. Similar provisions have existed in other Social Security Act programs, such as the former Aid to Families with Dependent Children (AFDC) Program (section 403(a)(3)) and the Title IV-E Foster Care and Adoption Assistance Program (section 474(a)(3)). Moreover, the Board has repeatedly held that under the cost principles, a grantee has the burden of documenting the allowability of costs charged to federal funds. *See, e.g., Nebraska Health and Human Services System*, DAB No. 1660, at 8 (1998); *Alabama Dept. of Finance*, DAB No. 1635, at 7-8 (1997), and cases cited therein. Oklahoma here ignored its basic obligation to document that federal funds which had been awarded for health insurance premiums for state employees working on federal programs were expended consistent with that objective.

Oklahoma argued that no benefits were lost to federal programs because state employees received full coverage and all health insurance benefits notwithstanding the transfer of the $31.5 million. No employees who work on federally funded programs, Oklahoma asserted, were denied health insurance coverage as a result of the $31.5 million transfer. Oklahoma argued that it transferred OSEEG1B reserves, but not the "benefit" to federal programs in the form of insurance coverage.

Oklahoma's argument fails to consider the essential nature of self-insurance funds. Self-insurance is the

practice of undertaking to absorb losses internally, without buying insurance from an outside source. *Pennsylvania Office of the Budget*, DAB No. 1234 (1991), *aff'd*, 996 F.2d 1505 (3rd Cir. 1993), *cert. denied*, 510 U.S. 1010 (1993). The very nature of self-insurance requires that a fund balance be carried over from year to year. "The self-insurance funds are, in essence, contingency funds to be tapped, or disbursed, only when claims are filed against them and paid by the State." *Pennsylvania* at 9. The fund balance is maintained in the form of a reserve fund, which generates investment income and protects the self-insurance plan against unforeseen funding shortfalls, such as could be caused by, in the case of a health insurance plan, underestimating upcoming employee health care claims. A sufficient reserve fund benefits health plan members by allowing lower contribution rates than would otherwise be required. See Texas Office of the Governor, DAB No. 1608, at 2 (1997). The disallowed funds here would have been placed in the OSEEGIB reserves, had Oklahoma not first removed them from the Clearing Fund and transferred them to higher education.

The importance of a reserve fund to a self-insurance system such as OSEEGIB is demonstrated by Oklahoma's concession that--

> Due in part to these transfers, OSEEGIB is presently in somewhat of a funding crisis, in that reserves are less than what is expected to be needed to cover future claims and premiums are rising dramatically.

Oklahoma Br. 3.

Thus, as a result of the transfer of the $31.5 million that would normally have funded the OSEEGIB reserves, premiums have been increased, resulting in potentially higher employer contributions and correspondingly higher claims for federal funding than would have been the case if the transferred funds had been maintained in the reserves.

Once the federal government participated in Oklahoma's employer contributions for health insurance for state employees who work on federal programs, the cost principles and other programmatic authorities required Oklahoma to use the federal funding for authorized programmatic purposes. Accordingly, to fulfill its burden as a grantee to document that federal funds were used for allowable program expenditures, Oklahoma was required to show that the federal funds used to pay health insurance premiums were either maintained in the OSEEGJB reserves, or used to pay claims and other OSEEGIB-related expenditures. From the point in time that these funds were removed from the reserves, the funds no longer benefited the original contributing programs and no longer fulfilled the terms of the original authorizing legislation. See Alabama at 8-9. As the Board observed in Texas, a grantee that receives funding for contributions to a reserve fund in a health insurance plan does not have the right to unilaterally make those reserves available to programs that had not contributed to them. Moreover, the grantee's affirmative duty to document that funding was used to support the reserve fund is not limited in time and continues for the duration of the health insurance plan. Texas at 8-9. When the Oklahoma legislature diverted state contributions from its health insurance system, prior to their being placed in the reserves, it abrogated not only its responsibility to the

federal government but also the expectations of the various state entities that had funded the premiums that they would be invested to pay for future claims and reduce future premium rates. The cost principles and the authorizing statutes and regulations created an ongoing obligation to account for these funds and to ensure that funds authorized to cover health insurance premiums remained in and continued to benefit the programs which funded the premiums and, through the premiums, the OSEEGIB reserves. See Alabama at 9-10.

Oklahoma argued, however, that the OSEEGIB was not a self-insurance fund as envisioned by OMB A-87, noting that it operates like any private health insurance provider, although it is a creation of the state. The record demonstrates otherwise. The State and Education Employees Group Insurance Act defines the health insurance plan (as well as the life and dental insurance plans) as. a self-insured plan. Okla. Stat. tit. 74, § 1303(i) (1995). The law also requires that all employee and employer contributions be deposited in a reserve fund, which is invested and used to pay claims and expenses.[6] *Id.*, § 1312. Oklahoma did not demonstrate why this statutory characterization was inaccurate or should be ignored. Furthermore, the descriptions in the record of the OSEEGIB and its operations -- such as the fact that it has maintained a large reserve fund, and that premiums

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[6] As noted above, the Act was amended in 1996 to provide that the first $31,500,000 collected in state employer premiums during the year beginning July 1, 1996 be diverted to higher education, with any funds remaining to be deposited in the appropriate OSEEG1B reserve fund. 1996 Okla. Sess. Laws Ch. 275, § 2; Okla.. tit. 74, § 1312.3(1998 electronic update).

are placed in the reserve fund and then invested -- indicate that it is a self-insurance plan. If the OSEEGIB was not a self-insurance, plan it would not need to maintain a large reserve fund, the size of which directly affects premium rates.

While not disputing DCA's calculation of the federal share of the diverted premiums, Oklahoma also argued that the disallowance should be reduced because state employees on whose behalf the premiums were paid comprised only 16% of OSEEGIB membership. Oklahoma argued that since the underlying transaction was a transfer of reserve funds accumulated on behalf of the entire OSEEGIB membership, Oklahoma's federally funded contributions for state employees represented a correspondingly small portion of the transferred funds. Oklahoma cited Texas for the principle that employees who had not contributed to reserve fund balances should not benefit at the expense of others who had, and argued that the disallowance should reflect the relative benefit of the reserve fund that was attributable to non-state employees.

Had Oklahoma paid the $31.5 million to higher education from accumulated OSEEGIB reserve funds, rather than from premium payments made on behalf of state employees only that had never been placed in the reserves, then this argument might have some merit. In that case, the non-state programs which contribute to OSEEGIB on behalf of their non-state employees, which presumably receive little or less federal funding than the state programs, would have borne the majority of the

$31.5 million transfer.[7] Significantly, however, the state legislature chose to transfer only premiums that Oklahoma contributed on behalf of its state employees. The federal government provided funding for those contributions, to the extent that those state employees worked on federally funded programs. Those federal funds were awarded to pay for health insurance premiums. By using them for other purposes, Oklahoma violated the cost principles and other applicable authorities, and incurred unallowable charges to federal awards. Those federal funds are directly traceable in the $31.5 million that was diverted to higher education. By mandating that the $31.5 million transfer be made from premiums contributed on behalf of state employees only, the Oklahoma legislature assured that the federal government would pay a much larger share of the $31.5 million transfer than if the payment had been made from the actual OSEEGIB reserves, which included contributions made on behalf of other, non-state employees. Thus, DCA was not required to reduce the disallowance 'to reflect the non-state employee membership of OSEEGIB, since those non-state employees' premiums were not transferred out of the OSEEGIB.[8]

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[7] Similarly, Oklahoma could have reduced existing state agency appropriations to provide the needed funds for higher education. Oklahoma Reply Br. at 3-4. In that case, if the transferred funds had not been used to claim federal funds for other purposes (such as health plan contributions), then Oklahoma would not have charged costs to federal awards in violation of the .cost principles and other applicable authorities.

[8] These reserve contributions arguably provided some benefit to federally funded programs to the extent state employees working on

APPENDIX 29

In *Alabama*, the Alabama legislature removed monies from the reserve fund maintained by Alabama's self-insurance plan for state-owned property and transferred them to the state's general fund, to be used for other purposes. The reserve fund included federal funds because many of Alabama's state and local government agencies administered federal grant programs and were entitled to have a portion of the insurance premiums on state property used in the administration of those programs reimbursed by the federal government. The Board there held that once the legislature transferred the funds out of the reserve, they no longer benefited the original contributing programs and could no longer be considered as having been applied to the costs of insurance premiums allocable to the federally funded programs to which they were charged. *Alabama* at 2, 8-9. That principle applies just as forcefully here, where Oklahoma never placed its employer health insurance premiums into the OSEEGJB reserves, but transferred them directly from the Clearing Fund. Once diverted, those funds no longer benefited, and were no longer allocable to, the federal programs which contributed them. Federal participation in Oklahoma's employer health insurance contributions was based on federal legislation authorizing the federal government to pay part of the costs of administering certain programs, including the costs of fringe benefits such as health

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federally funded programs might draw on the reserves. Thus, our decision does not preclude DCA from allowing some appropriate reduction to the disallowance if Oklahoma can demonstrate that it made necessary retroactive adjustments in how insurance premiums for the years in question are charged and can demonstrate to DCA's satisfaction that it meets other federal requirements such as for non-federal share.

insurance for state employees. *See Pennsylvania* at 10, *Alabama* at 9-10. Oklahoma failed in its duty to use the federal funds for the costs of self-insurance when it removed the premiums from the Clearing Fund and used them for higher education.

2. DCA may not recover imputed interest on the transferred federal funds.

DCA disallowed $288,392 in interest imputed on the $7,426,672 disallowance from September 1, 1996 to October 8, 1997, the date of DCA's overpayment determination letter to Oklahoma. DCA Br. 4-5, 9-10, Aft. D. DCA sought to recover the interest under the following provision of OMB Circular A-87:

> (5) Whenever funds are transferred fiom a self-insurance reserve to other accounts (e.g., general fund), refunds shall be made to the Federal Government for its share of funds transferred, including earned or imputed interest from the date of transfer.

OMB A-87, Alt. B, ¶ 25.d.(5).

We find that this provision is not applicable here because the disallowed funds were never deposited in the OSEEGIB reserves. Instead, Oklahoma's employer insurance contributions were collected by the statutorily-created Clearing Fund, which transferred them directly to Oklahoma State Regents for Higher Education; only funds in excess of the transferred $31.5 million were

deposited in the OSEEGIB reserves. Because the disallowed federal funds never became part of the OSEEGIB reserves, they were not transferred out of a reserve fund within the meaning of the cited provision of OMB A-87.

This Board and the courts have held in a variety of contexts that grantees may be held accountable for interest actually earned by them on investments of federal grant funds in their possession. *See, e.g. Pennsylvania; Wisconsin Dept. of Health and Social Services*, DAB No. 623 (1985); *New York State Dept. of Social Services*, DAB No. 588 (1984); *New Jersey Dept. of Human Services*, DAB No. 480 (1983), *aff'd* Civil No. 84-277 1 (N.J. Nov. 13, 1986); and *North Carolina Dept. of Human Resources*, DAB No. 361 (1982), *aff'd* 584 F.Supp. 179 (E.D. N.C. 1984). The Board has also held, however, that in the absence of express authority to recover imputed interest, a federal agency may not recover interest on federal funds that could have been named by the grantee but was not. *Alabama; Pennsylvania; New York State Dept. of Social Services*, DAB No. 910 (1987). Thus, in the absence of an applicable provision permitting the refund of imputed interest, DCA may only recover interest that was actually earned by the federal funds that Oklahoma received for insurance premiums but used for other purposes.

DCA argued that the provision of OMB A-87 permitting recovery of imputed interest on federal funds transferred out of a self-insurance reserve applied here because (as Oklahoma argued) the transfer was in effect a transfer of OSEEGIB reserve funds.

We disagree. Oklahoma law called for the Clearing Fund to transfer the funds to higher education instead of

depositing them in the OSEEGEB reserves, a point which DCA recognized in its statement that the transfer prevented the funds from being deposited in the OSEEGJB reserves. DCA Br. 10. As Oklahoma argued, if the transfer had been made from funds in the OSEEGJB reserves, then the transferred funds would have included premiums paid on behalf of all participants in OSEEGIB, and not just state employees, who comprise only 16% of OSEEGIB members, a figure which DCA did not dispute. In that case, the federal share of the $31.5 million that was transferred to higher education would have been smaller than the $7,426,672 currently disallowed.

DCA may thus recover only interest that Oklahoma actually earned on the $7,426,672 that was awarded for insurance premiums but spent on other purposes. DCA's October 8, 1997 determination letter to Oklahoma states that DCA was recovering imputed interest, and the record contains no showing by DCA that Oklahoma actually earned any interest on the transferred funds. If DCA can establish that Oklahoma earned interest on federal funds before applying them to higher education, then it may reinstate a disallowance for the interest actually earned.

Conclusion

Based on the above analysis, we sustain the disallowance of $7,426,672 in federal funds that Oklahoma transferred out of its group insurance system. We reverse the disallowance of $288,392 in imputed interest on the transferred funds.

APPENDIX 33

/s/ Judith a. Ballard
Judith A. Ballard

/s/ Cecilia Sparks Ford
Cecilia Sparks Ford

/s/ Donald F. Garrett
Donald F. Garrett

APPENDIX 34

31 U.S.C.A. § 1301(a) (1994)

§ 1301. Application.

(a) Appropriations shall be applied only to the objects for which the appropriations were made except as otherwise provided by law.

APPENDIX 35

OKLA. STAT. tit. 74, § 1310

OKLAHOMA STATE AND EDUCATION EMPLOYEES GROUP INSURANCE ACT

§ 1310. Payment to Funds.

A. Except as provided in subsection B of this section, each state agency participating in the Group Insurance Plans shall appropriate and pay to the appropriate reserve fund an amount to be set by the State and Education Employees Group Insurance Board for each employee other than education employees per month enrolled in said Plans, from funds appropriated to said agency or from other funds available to such agency for operational purposes.

B. During the fiscal year ending June 30, 1997, each state agency participating in the Group Insurance Plans shall appropriate and pay to the State Employees Group Insurance Clearing Fund an amount to be set by the State and Education Employees Group Insurance Board for each employee other than education employees per month enrolled in said Plans, from funds appropriated to said agency or from other funds available to such agency for operational purposes.

APPENDIX 36

OKLA. STAT. tit. 74, § 1312

OKLAHOMA STATE AND EDUCATION EMPLOYEES GROUP INSURANCE ACT

§ 1312. Health and Dental Insurance Reserve Fund.

(1) Except as otherwise provided by law, all employee and employer contributions, appropriations and dividend payments related to the health and dental plans administered by the State and Education Employees Group Insurance Board shall be deposited in a fund in the State Treasury which is hereby created and which shall be known as the Health and Dental Insurance Reserve Fund. The money in such fund shall be invested by the Board in the manner specified in Section 1305.1 of this title. Investment income of the fund shall be added to the fund. Money payable to the claims administrator and all expenses in connection with the plans shall be paid from the fund. The Board shall have responsibility for management of the fund.

(2) All monies in the Health and Dental Insurance Reserve Fund that are reserves for the life insurance plan administered by the State and Education Employees Group Insurance Board shall be transferred to the Life Insurance Reserve Fund on July 1, 1989.

APPENDIX 37

OKLA. STAT. tit. 74, § 1312.3

OKLAHOMA STATE AND EDUCATION EMPLOYEES GROUP INSURANCE ACT

§ 1312.3. State Employees Group Insurance Clearing Fund.

There is hereby created in the State Treasury, the State Employees Group Insurance Clearing Fund. The monies paid to the State Employees Group Insurance Clearing Fund pursuant to Section 1310 of this title shall be distributed as follows:

1. The first Thirty-one Million Five Hundred Thousand Dollars ($31,500,000.00) received after the effective date of this act during the fiscal year beginning July 1, 1996, shall be distributed to the Oklahoma State Regents for Higher Education; and

2. The balance thereof shall be distributed to and deposited in the appropriate reserve fund as directed by the State and Education Employees Group Insurance Board.

APPENDIX 38

OKLA. STAT. tit. 74 § 1363.12

OKLAHOMA STATE EMPLOYEES BENEFITS ACT

§ 1363. Definitions.

The following words and phrases as used in this act, unless a different meaning is clearly required by the context, shall have the following meanings:

* * *

12. "Flexible benefit allowance" means the annual amounts credited by the participating employer for each participant for the purchase of benefits under the plan;

APPENDIX 39

OKLA. STAT. tit. 74 § 1370

OKLAHOMA STATE EMPLOYEES BENEFITS ACT

§ 1370. Flexible Benefit Allowance.

A. Subject to the requirement that a participant must elect at least the default benefits, or the basic plan, flexible benefit dollars may be used to purchase any of the benefits offered by the Oklahoma State Employees Benefits Council under the flexible benefits plan. A participant's flexible benefit dollars for a plan year shall consist of the sum of (1) flexible benefit allowance credited to a participant by the participating employer, and (2) pay conversion dollars elected by a participant.

B. Each participant shall be credited annually with a specified amount as a flexible benefit allowance which shall be available for the purchase of benefits. The amount of the flexible benefit allowance credited to each participant shall be communicated to him or her prior to the enrollment period for each plan year.

C. For the plan year ending December 31, 2001, and each plan year thereafter, the amount of a participant's benefit allowance, which shall be the total amount the employer contributes for the payment of insurance premiums or other benefits, shall be:

1. The greater of Two Hundred Sixty-two Dollars and nineteen cents ($262.19) per month or an amount equal to the sum of the average monthly premiums of all high option health insurance plans, the average

monthly premiums of the dental plans, the monthly premium of the disability plan, and the monthly premium of the basic life insurance plan offered to state employees or the amount determined by the Council based on a formula for determining a participant's benefit credits consistent with the requirements of 26 U.S.C., Section 125(g)(2) and regulations thereunder; or

2. The greater of Two Hundred Twenty-four Dollars and sixty-nine cents ($224.69) per month or an amount equal to the sum of the average monthly premiums of all high option health insurance plans, the average monthly premiums of the dental plans, the monthly premium of the disability plan, and the monthly premium of the basic life insurance plan offered to state employees plus one of the additional amounts as follows for participants who elect to include one or more dependents:

a. for a spouse, seventy-five percent (75%) of the average price of all high option benefit plans available for coverage of a spouse,

b. for one child, seventy-five percent (75%) of the average price of all high option benefit plans available for coverage of one child,

c. for two or more children,

seventy-five percent (75%) of the average price of all high option benefit plans available for coverage of two or more children,

d. for a spouse and one child, seventy-five percent (75%) of the average price of all high option benefit plans available for coverage of a spouse and one child, or

e. for a spouse and two or more children, seventy-five percent (75%) of the average price of all high option benefit plans available for coverage of a spouse and two or more children.

D. This section shall not prohibit payments for supplemental health insurance coverage made pursuant to Section 1314.4 of this title or payments for the cost of providing health insurance coverage for dependents of employees of the Grand River Dam Authority.

E. If a participant desires to buy benefits whose sum total of benefit prices is in excess of his or her flexible benefit allowance, the participant may elect to use pay conversion dollars to purchase such excess benefits. Pay conversion dollars may be elected through a salary reduction agreement made pursuant to the election procedures of Section 1371 of this title. The elected amount shall be deducted from the participant's compensation in equal amounts each pay period over the plan year. On termination of employment during a plan year, a

participant shall have no obligation to pay the participating employer any pay conversion dollars allocated to the portion of the plan year after the participant's termination of employment.

F. If a participant elects benefits whose sum total of benefit prices is less than his or her flexible benefit allowance, he or she shall receive any excess flexible benefit allowance as taxable compensation. Such taxable compensation will be paid in substantially equal amounts each pay period over the plan year. On termination during a plan year, a participant shall have no right to receive any such taxable cash compensation allocated to the portion of the plan year after the participant's termination. Nothing herein shall affect a participant's obligation to elect the minimum benefits or to accept the default benefits of the plan with corresponding reduction in the sum of his or her flexible benefit allowance equal to the sum total benefit price of such minimum benefits or default benefits.

APPENDIX 43

OKLA. STAT. tit. 74 § 1371

OKLAHOMA STATE EMPLOYEES BENEFITS ACT

§ 1371. Election of Benefit Plans – Plans Offered by Health Maintenance Organizations – Default Benefits.

A. All participants must purchase at least the basic plan. On or before January 1 of the plan year beginning July 1, 2001, and July 1 of any plan year beginning after January 1, 2002, the Oklahoma State Employees Benefits Council shall design the basic plan for the next plan year to insure that the basic plan provides adequate coverage to all participants. All benefit plans, whether offered by the State and Education Employees Group Insurance Board, a health maintenance organization or other vendors shall meet the minimum requirements set by the Council for the basic plan.

B. The Board shall offer health, disability, life and dental coverage to all participants and their dependents. For health, dental, disability and life coverage, the Board shall offer plans at the basic benefit level established by the Council, and in addition, may offer benefit plans that provide an enhanced level of benefits. The Board shall be responsible for determining the plan design and the benefit price for the plans that they offer. In setting health insurance premiums for active employees and for retirees under sixty-five (65) years of age, the Board shall set the monthly premium for active employees at a maximum of Ninety Dollars ($90.00) less than the monthly premium

for retirees under sixty-five (65) years of age. Nothing in this subsection shall be construed as prohibiting the Board from offering additional medical plans, provided that any medical plan offered to participants shall meet or exceed the benefits provided in the medical portion of the basic plan.

C. In lieu of electing any of the preceding medical benefit plans, a participant may elect medical coverage by any health maintenance organization made available to participants by the Council. The benefit price of any health maintenance organization shall be determined on a competitive bid basis. Contracts for said plans shall not be subject to the provisions of the Oklahoma Central Purchasing Act, Section 85.1 et seq. of this title. The Council shall promulgate rules establishing appropriate competitive bidding criteria and procedures for contracts awarded for flexible benefits plans. All plans offered by health maintenance organizations meeting the bid requirements as determined by the Council shall be accepted. The Council shall have the authority to reject the bid or restrict enrollment in any health maintenance organization for which the Council determines the benefit price to be excessive. The Council shall have the authority to reject any plan that does not meet the bid requirements. All bidders shall submit along with their bid a notarized, sworn statement as provided by Section 85.22 of this title. In setting health insurance premiums for active employees and for retirees under sixty-five (65) years of age, HMOs, self-insured organizations and prepaid plans shall set the monthly premium for active employees at a maximum of Ninety Dollars ($90.00) less than the monthly premium for retirees under sixty-five (65) years of age.

D. Nothing in this section shall be construed as prohibiting the Council from offering additional qualified benefit plans or currently taxable benefit plans.

E. Each employee of a participating employer who meets the eligibility requirements for participation in the flexible benefits plan shall make an annual election of benefits under the plan during an enrollment period to be held prior to the beginning of each plan year. The enrollment period dates will be determined annually and will be announced by the Council, providing the enrollment period shall end no later than thirty (30) days before the beginning of the plan year.

Each such employee shall make an irrevocable advance election for the plan year or the remainder thereof pursuant to such procedures as the Council shall prescribe. Any such employee who fails to make a proper election under the plan shall, nevertheless, be a participant in the plan and shall be deemed to have purchased the default benefits described in this section.

F. The Council shall prescribe the forms that participants will be required to use in making their elections, and may prescribe deadlines and other procedures for filing the elections.

G. Any participant who, in the first year for which he or she is eligible to participate in the plan, fails to make a proper election under the plan in conformance with the procedures set forth in this section or as prescribed by the Council shall be deemed automatically to have purchased the default benefits. The default benefits shall be the same

as the basic plan benefits. Any participant who, after having participated in the plan during the previous plan year, fails to make a proper election under the plan in conformance with the procedures set forth in this section or prescribed by the Council, shall be deemed automatically to have purchased the same benefits which the participant purchased in the immediately preceding plan year, except that the participant shall not be deemed to have elected coverage under the health care reimbursement account plan or the dependent care reimbursement account plan.

H. Benefit plan contracts with the Board, health maintenance organizations, and other third party insurance vendors shall provide for a risk adjustment factor for adverse selection that may occur, as determined by the Council, based on generally accepted actuarial principles.

APPENDIX 47

OFFICE OF MANAGEMENT AND BUDGET CIRCULAR A-87

ATTACHMENT A – GENERAL PRINCIPLES FOR DETERMINING ALLOWABLE COSTS

A. Purpose and Scope

1. Objectives. This Attachment establishes principles for determining the allowable costs incurred by State, local, and federally-recognized Indian tribal governments (governmental units) under grants, cost reimbursement contracts, and other agreements with the Federal Government (collectively referred to in this Circular as "Federal awards"). The principles are for the purpose of cost determination and are not intended to identify the circumstances or dictate the extent of Federal or governmental unit participation in the financing of a particular program or project. The principles are designed to provide that Federal awards bear their fair share of cost recognized under these principles except where restricted or prohibited by law. Provision for profit or other increment above cost is outside the scope of this Circular.

2. Policy guides.

a. The application of these principles is based on the fundamental premises that:

(1) Governmental units are responsible for the efficient and effective administration of Federal awards through the application of sound management practices.

(2) Governmental units assume responsibility for administering Federal funds in a manner consistent with underlying agreements, program objectives, and the terms and conditions of the Federal award.

(3) Each governmental unit, in recognition of its own unique combination of staff, facilities, and experience, will have the primary responsibility for employing whatever form of organization and management techniques may be necessary to assure proper and efficient administration of Federal awards.

b. Federal agencies should work with States or localities which wish to test alternative mechanisms for paying costs for administering Federal programs. The Office of Management and Budget (OMB) encourages Federal agencies to test fee-for-service alternatives as a replacement for current cost-reimbursement payment methods in response to the National Performance Review's (NPR) recommendation. The NPR recommended the fee-for-service approach to reduce the burden associated with maintaining systems for charging administrative costs

to Federal programs and preparing and approving cost allocation plans. This approach should also increase incentives for administrative efficiencies and improve outcomes.

3. Application.

a. These principles will be applied by all Federal agencies in determining costs incurred by governmental units under Federal awards (including subawards) except those with (1) Publicly-financed educational institutions subject to OMB Circular A-21, "Cost Principles for Educational Institutions," and (2) programs administered by publicly-owned hospitals and other providers of medical care that are subject to requirements promulgated by the sponsoring Federal agencies. However, this Circular does apply to all central service and department/agency costs that are allocated or billed to those educational institutions, hospitals, and other providers of medical care or services by other State and local government departments and agencies.

b. All subawards are subject to those Federal cost principles applicable to the particular organization concerned. Thus, if a subaward is to a governmental unit (other than a college, university or hospital), this Circular shall apply; if a subaward is to a

commercial organization, the cost principles applicable to commercial organizations shall apply; if a subaward is to a college or university, Circular A-21 shall apply; if a subaward is to a hospital, the cost principles used by the Federal awarding agency for awards to hospitals shall apply, subject to the provisions of subsection A.3.a. of this Attachment; if a subaward is to some other non-profit organization, Circular A- 122, "Cost Principles for Non-Profit Organizations," shall apply.

c. These principles shall be used as a guide in the pricing of fixed price arrangements where costs are used in determining the appropriate price.

d. Where a Federal contract awarded to a governmental unit incorporates a Cost Accounting Standards (CAS) clause, the requirements of that clause shall apply. In such cases, the governmental unit and the cognizant Federal agency shall establish an appropriate advance agreement on how the governmental unit will comply with applicable CAS requirements when estimating, accumulating and reporting costs under CAS-covered contracts. The agreement shall indicate that OMB Circular A-87 requirements will be applied to other Federal awards. In all cases, only

one set of records needs to be maintained by the governmental unit.

* * *

C. Basic Guidelines

1. Factors affecting allowability of costs. To be allowable under Federal awards, costs must meet the following general criteria:

a. Be necessary and reasonable for proper and efficient performance and administration of Federal awards.

b. Be allocable to Federal awards under the provisions of this Circular.

c. Be authorized or not prohibited under State or local laws or regulations.

d. Conform to any limitations or exclusions set forth in these principles, Federal laws, terms and conditions of the Federal award, or other governing regulations as to types or amounts of cost items.

e. Be consistent with policies, regulations, and procedures that apply uniformly to both Federal awards and other activities of the governmental unit.

f. Be accorded consistent treatment. A cost

may not be assigned to a Federal award as a direct cost if any other cost incurred for the same purpose in like circumstances has been allocated to the Federal award as an indirect cost.

g. Except as otherwise provided for in this Circular, be determined in accordance with generally accepted accounting principles.

h. Not be included as a cost or used to meet cost sharing or matching requirements of any other Federal award in either the current or a prior period, except as specifically provided by Federal law or regulation.

i. Be the net of all applicable credits.

j. Be adequately documented.

2. Reasonable costs. A cost is reasonable if, in its nature and amount, it does not exceed that which would be incurred by a prudent person under the circumstances prevailing at the time the decision was made to incur the cost. The question of reasonableness is particularly important when governmental units or components are predominately federally-funded. In determining reasonableness of a given cost, consideration shall be given to:

a. Whether the cost is of a type generally recognized as ordinary and necessary for

the operation of the governmental unit or the performance of the Federal award.

b. The restraints or requirements imposed by such factors as: sound business practices; arms length bargaining; Federal, State and other laws and regulations; and, terms and conditions of the Federal award.

c. Market prices for comparable goods or services.

d. Whether the individuals concerned acted with prudence in the circumstances considering their responsibilities to the governmental unit, its employees, the public at large, and the Federal Government.

e. Significant deviations from the established practices of the governmental unit which may unjustifiably increase the Federal award's cost.

3. Allocable costs.

a. A cost is allocable to a particular cost objective if the goods or services involved are chargeable or assignable to such cost objective in accordance with relative benefits received.

b. All activities which benefit from the governmental unit's indirect cost, including

unallowable activities and services donated to the governmental unit by third parties, will receive an appropriate allocation of indirect costs.

c. Any cost allocable to a particular Federal award or cost objective under the principles provided for in this Circular may not be charged to other Federal awards to overcome fund deficiencies, to avoid restrictions imposed by law or terms of the Federal awards, or for other reasons. However, this prohibition would not preclude governmental units from shifting costs that are allowable under two or more awards in accordance with existing program agreements.

d. Where an accumulation of indirect costs will ultimately result in charges to a Federal award, a cost allocation plan will be required as described in Attachments C, D, and E.

4. Applicable credits.

a. Applicable credits refer to those receipts or reduction of expenditure- type transactions that offset or reduce expense items allocable to Federal awards as direct or indirect costs. Examples of such transactions are: purchase discounts, rebates or allowances, recoveries or indemnities on losses, insurance refunds or

rebates, and adjustments of overpayments or erroneous charges. To the extent that such credits accruing to or received by the governmental unit relate to allowable costs, they shall be credited to the Federal award either as a cost reduction or cash refund, as appropriate.

b. In some instances, the amounts received from the Federal Government to finance activities or service operations of the governmental unit should be treated as applicable credits. Specifically, the concept of netting such credit items (including any amounts used to meet cost sharing or matching requirements) should be recognized in determining the rates or amounts to be charged to Federal awards. (See Attachment B, item 15, "Depreciation and use allowances," for areas of potential application in the matter of Federal financing of activities.)

APPENDIX 56

OFFICE OF MANAGEMENT AND BUDGET CIRCULAR A-87

ATTACHMENT B – SELECTED ITEMS OF COST

11. Compensation for personnel services.

* * *

d. Fringe benefits.

(1) Fringe benefits are allowances and services provided by employers to their employees as compensation in addition to regular salaries and wages. Fringe benefits include, but are not limited to, the costs of leave, employee insurance, pensions, and unemployment benefit plans. Except as provided elsewhere in these principles, the costs of fringe benefits are allowable to the extent that the benefits are reasonable and are required by law, governmental unit-employee agreement, or an established policy of the governmental unit.

(2) The cost of fringe benefits in the form of regular compensation paid to employees during periods of authorized absences from the job, such as for annual leave, sick leave, holidays, court leave, military leave, and other similar benefits, are allowable if: (a) they are provided under established written leave policies; (b) the costs are equitably allocated to all related activities, including Federal awards; and, (c) the

accounting basis (cash or accrual) selected for costing each type of leave is consistently followed by the governmental unit.

(3) When a governmental unit uses the cash basis of accounting, the cost of leave is recognized in the period that the leave is taken and paid for. Payments for unused leave when an employee retires or terminates employment are allowable in the year of payment provided they are allocated as a general administrative expense to all activities of the governmental unit or component.

(4) The accrual basis may be only used for those types of leave for which a liability as defined by Generally Accepted Accounting Principles (GAAP) exists when the leave is earned. When a governmental unit uses the accrual basis of accounting, in accordance with GAAP, allowable leave costs are the lesser of the amount accrued or funded.

(5) The cost of fringe benefits in the form of employer contributions or expenses for social security; employee life, health, unemployment, and worker's compensation insurance (except as indicated in section 25, Insurance and indemnification); pension plan costs (see subsection e.); and other similar benefits are allowable, provided such benefits are granted under

established written policies. Such benefits, whether treated as indirect costs or as direct costs, shall be allocated to Federal awards and all other activities in a manner consistent with the pattern of benefits attributable to the individuals or group(s) of employees whose salaries and wages are chargeable to such Federal awards and other activities.

Supreme Court, U.S.
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(2)

No. 02-714

In the Supreme Court of the United States

THE STATE OF OKLAHOMA, EX REL.,
OFFICE OF STATE FINANCE, PETITIONER

v.

TOMMY G. THOMPSON, SECRETARY OF HEALTH AND HUMAN SERVICES, EX REL., DEPARTMENT OF HEALTH AND HUMAN SERVICES, ET AL.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE TENTH CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

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QUESTIONS PRESENTED

1. Whether Office of Management and Budget Circular No. A-87, which establishes the standards for determining the costs of federal awards carried out through grants and other agreements with state and local governments, impermissibly interferes with the State of Oklahoma's management of its fiscal affairs.

2. Whether a State may use federal funds, which are provided as reimbursement for the cost of health benefits for state employees who work on federally funded programs and which are intended for deposit in the state's self-insurance reserve fund, for nonfederal purposes.

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In the Supreme Court of the United States

No. 02-714

THE STATE OF OKLAHOMA, EX REL.,
OFFICE OF STATE FINANCE, PETITIONER

v.

TOMMY G. THOMPSON, SECRETARY OF HEALTH AND HUMAN SERVICES, EX REL., DEPARTMENT OF HEALTH AND HUMAN SERVICES, ET AL.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE TENTH CIRCUIT

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OPINIONS BELOW

The opinion of the court of appeals (Pet. App. 2-8) is reported at 292 F.3d 1261. The order of the district court is unreported.[1] The final decision of the Department of Health and Human Services Departmental Appeals Board (Pet. App. 17-33) is *available in* 1998 WL 673808.

[1] Petitioner's appendix contains a preliminary district court ruling on issues not raised by the petition (Pet. App. 11-16), but does not contain the district court's final order and judgment. For the Court's convenience, they are included at Appendix, *infra*, 1a-7a.

JURISDICTION

The judgment of the court of appeals (Pet. App. 1) was entered on June 12, 2002. A petition for rehearing was denied on August 12, 2002 (Pet. App. 9-10). The petition for a writ of certiorari was filed on November 12, 2002 (following a holiday). The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

STATEMENT

1. Numerous federal benefit and grant programs are implemented jointly by the federal government and the States. The statutes that create those programs and appropriate funding for them also authorize the use of federal funds to reimburse the States for certain costs they incur in administering the programs. See, *e.g.*, 42 U.S.C. 1396b(a)(7) (reimbursement of amounts "necessary * * * for the proper and efficient administration of the State [Medicaid] plan"). In addition, general federal appropriations law mandates that "[a]ppropriations shall be applied only to the objects for which the appropriations were made except as otherwise provided by law." 31 U.S.C. 1301(a).

In Circular No. A-87, "Cost Principles for State, Local, and Indian Tribal Governments," the Office of Management and Budget (OMB) has established uniform standards for determining the allowable costs of administering federal programs. 60 Fed. Reg. 26,484, 26,489 (1995). A fundamental premise of Circular No. A-87 is that governmental units, such as States, "are responsible for the efficient and effective administration of Federal awards through the application of sound management practices." *Id.* at 26,490. States are also expected to "administer[] Federal funds in a manner consistent with underlying agreements, pro-

gram objectives, and the terms and conditions of the Federal award." *Ibid.*

To be "allowable," costs must meet certain general criteria. For example, costs must be "necessary and reasonable" and "allocable to Federal awards." 60 Fed. Reg. at 26,491. "A cost is allocable to a particular cost objective if the goods or services involved are chargeable or assignable to such cost objective in accordance with relative benefits received." *Id.* at 26,492. Among the specific costs that are allowable is compensation for personnel services, including salaries and fringe benefits, provided that such costs satisfy the general criteria of Circular No. A-87. *Id.* at 26,494. "Fringe benefits" explicitly include "*employer* contributions" for employee health insurance. *Ibid.* (emphasis added). Excluded from the definition of costs, however, are "transfers to a general or similar fund." *Id.* at 26,491.

OMB has delegated to the Department of Health and Human Services (HHS) responsibility for reviewing Statewide Central Service Cost Allocation Plans. 60 Fed. Reg. at 26,501. Those plans include "all central service costs that will be claimed (either as a billed or an allocated cost) under Federal awards" and must contain certain information. *Ibid.* For example, Circular No. A-87 sets forth specific requirements pertaining to state "self- insurance" funds, through which States provide health and other benefits to their employees and insure state property. With respect to a self-insurance plan, a State's cost allocation plan must include, *inter alia*, the self-insurance fund balance sheet; a statement of revenue and expenses; a list of all non-operating transfers into and out of the fund; an explanation of how fund contributions are determined; and a description of the procedures used to charge fund contributions to benefitted activities. *Id.* at 26,502.

The state plan also must provide detailed information concerning the self-insurance fund's reserve level. Contributions to reserves must be based on "sound actuarial principles," and "[r]eserve levels must be analyzed and updated at least biennially for each major risk being insured." 60 Fed. Reg. at 26,499. Reserve levels in excess of amounts correlating to claims "must be identified and justified in the cost allocation plan." *Ibid.* Moreover, if funds are transferred from a self-insurance reserve fund to a general or other fund, the federal government must be reimbursed for its share of the transferred funds, plus interest. *Ibid.*

HHS's Division of Cost Allocation (DCA) reviews state plans to ensure that the federal government is bearing its proper share of the costs of administering joint federal-state programs. As a result of such reviews, DCA may "disallow" a claim for federal funding, and a State may request reconsideration. See, *e.g.*, 42 U.S.C. 1316(d). HHS's Departmental Appeals Board renders the final decision in such appeals, based on the State's and DCA's written submissions and/or the record developed at a hearing. See generally *Board of Trs. of the Pub. Employees' Ret. Fund* v. *Sullivan*, 936 F.2d 988 (7th Cir. 1991), cert. denied, 502 U.S. 1072 (1992).

2. As part of their compensation, employees of petitioner, the State of Oklahoma, are given a "flexible benefit allowance," an amount credited by their employing State agencies for the purchase of health insurance and other benefits. Oklahoma State Employees Benefits Act, Okla. Stat. tit. 74, §§ 1363.12, 1370.B (Supp. 2002). Employees must use that credit to purchase a health insurance plan, but they have the option of choosing insurance from either a private insurer or the State's own self-insurance plan. *Id.*

§ 1371. Petitioner's health insurance plan was established by the State and Education Employees Group Insurance Act (Group Insurance Act), Okla. Stat. tit. 74, §§ 1301 *et seq.*, and is administered by the Oklahoma State and Education Employees Group Insurance Board (OSEEGIB). In addition to state employees, employees of local governments, school districts, and other groups may also participate in petitioner's self-insurance plan. Pet. App. 4.

Ordinarily, "all employee and employer contributions" to the OSEEGIB health insurance plan are deposited directly into the State Treasury's Health and Dental Insurance Reserve Fund (Reserve Fund). Okla. Stat. tit. 74, § 1312(1) (1995).[2] The money in the Reserve Fund is used to pay claims and administrative expenses and to generate investment income. *Ibid.* In a 1996 amendment to the Group Insurance Act, however, the Oklahoma legislature directed "each state agency" participating in the State's self-insurance plans to "appropriate and pay to the State Employees Group Insurance Clearing Fund" (Clearing Fund), during fiscal year 1997, "an amount to be set by the [OSEEGIB] for each employee * * * enrolled in said Plans, from funds appropriated to said agency or *from other funds available to such agency for operational purposes.*" *Id.* § 1310.B (Supp. 2002) (emphasis added). The first $31.5 million paid to the Clearing Fund was to "be distributed to the Oklahoma State Regents for Higher Education," with any balance distributed as directed by the OSEEGIB. *Id.* § 1312.3.

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[2] In addition to the State's contribution for employee health insurance that it provides as a fringe benefit, employees also contribute through payroll deductions from their salaries. Okla. Stat. tit. 74, § 1311 (1995).

3. After learning of the transfer of $31.5 million to the Clearing Fund rather than to the Reserve Fund, DCA issued a Notice of Disallowance to petitioner in October 1997. The Notice explained that the transfer of the federal share of the $31.5 million violated the cost principles of Circular No. A-87—specifically, the requirement that a cost be "allocable to a particular cost objective." 60 Fed. Reg. at 26,492. Because costs charged to federally funded programs for the specific purpose of providing health benefits for state employees working on those federal programs were diverted to other purposes, the federal programs received no benefit from the expenditure of those funds. DCA initially calculated the federal share of the transferred funds to be approximately $10.4 million.

In its response to the Notice of Disallowance, petitioner acknowledged that the transfer was "problematic" and that "some reimbursement is due the Federal Government." Pet. C.A. App. 328. Petitioner, however, disagreed with the amount of the disallowance and contended that approximately $1.16 million was a more appropriate figure. After considering petitioner's arguments and relying on petitioner's own financial data, DCA recalculated the disallowance and determined that the federal share of the $31.5 million transferred from OSEEGIB funds to other State purposes was approximately 23.58%, or $7,426,672. With imputed interest income, the total disallowance was $7,715,064.

4. Petitioner appealed the disallowance to the Departmental Appeals Board (Board), which upheld the $7,426,672 disallowance. Pet. App. 18. The Board explained that the federal government provided federal funds to petitioner to pay a portion of the State's contributions for health insurance for state employees

who work on federally funded programs. Ordinarily, petitioner would have deposited those federal funds directly into the OSEEGIB Reserve Fund, "where they would have generated income and been used to pay health insurance claims and other related expenses." *Id.* at 21-22. But, the Board explained, when petitioner used the federal portion of the $31.5 million for State higher education purposes instead of depositing it into the State's group insurance system, it violated basic federal cost principles. The federal funds at issue were not awarded for higher education purposes and, thus, were not allocable to the particular federal purposes for which they had been awarded. Accordingly, they were not allowable costs under Circular No. A-87. *Id.* at 22. The Board also concluded that petitioner's use of the federal money for State education purposes violated federal appropriations law, 31 U.S.C. 1301(a), as well as the particular federal statutes authorizing reimbursement of the costs of administering various grant and benefit programs. Pet. App. 22-23. "From the point in time that these funds were removed from the reserves, the funds no longer benefited the original contributing programs and no longer fulfilled the terms of the original authorizing legislation." *Id.* at 25.

The Board rejected petitioner's argument that the federal government got what it paid for because State employees received health insurance benefits, notwithstanding the $31.5 million transfer. That argument, it explained, is contrary to "the essential nature of self-insurance funds": because a self-insurance system absorbs losses internally, a fund balance—"maintained in the form of a reserve fund, which generates investment income and protects the self-insurance plan against unforeseen funding shortfalls"—must be carried over from year to year. Pet. App. 23-24. Accord-

ingly, the Board reasoned, the federal government thus expected that the funds that petitioner placed in the Clearing Fund and used for higher education would be deposited in the OSEEGIB Reserve Fund and used for the payment of claims, administrative costs, and investment purposes, as State law requires. Group Insurance Act, Okla. Stat. tit. 74, § 1312(1) (1995). Quoting from petitioner's brief, the Board found that, "[d]ue in part to these transfers, OSEEGIB is presently in somewhat of a funding crisis, in that reserves are less than what is expected to be needed to cover future claims and premiums are rising dramatically." Pet. App. 24.

The Board also rejected petitioner's objection to how the federal share of the transfer to the Clearing Fund was calculated. Pet. App. 27-28. The Board agreed with petitioner, however, that it was not obligated for imputed interest income on the transferred federal funds. *Id.* at 30-32. The Board thus upheld a disallowance of $7,426,672. *Id.* at 32.

5. Petitioner filed suit in federal district court, challenging the Board's decision as contrary to "the laws and regulations governing federal grant programs" and as arbitrary and capricious. Resp. C.A. Supp. App. 10-11 (Am. Compl.). In the alternative, petitioner sought a remand for a recalculation of the amount of the disallowance. *Id.* at 13.

The district court affirmed the Board's decision, App., *infra*, 1a-7a, holding that the decision is not arbitrary or capricious, and that "it is in accord with federal cost allocation principles and is based on substantial evidence," *id.* at 7a.[3]

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[3] In an earlier ruling, the district court dismissed Oklahoma's claim for damages based on unjust enrichment and *quantum meruit* theories. Pet. App. 11-16.

6. The court of appeals affirmed the district court's decision "in all respects." Pet. App. 8.[4] The court also noted that "cost," as defined in Circular No. A-87, explicitly excludes "transfers to a general or similar fund." *Ibid.* (quoting 60 Fed. Reg. at 26,491). Thus, the funds diverted from the OSEEGIB Reserve Fund to the Clearing Fund "fail[ed] to qualify as a reimbursable cost in the first instance." *Ibid.*[5]

ARGUMENT

The judgment of the court of appeals is correct, and it does not conflict with any decision of this Court or any other court of appeals. The questions presented thus do not warrant this Court's plenary review.

1. Petitioner argues (Pet. 9-10) that Circular No. A-87, as applied in this case, impermissibly and unconstitutionally interferes with the State's sovereign affairs. Because petitioner did not raise any constitutional claim below, however, the court of appeals did not address petitioner's contention. This Court should accordingly decline to do so in the first instance. *Glover* v. *United States*, 531 U.S. 198, 205 (2001) (the Court does not ordinarily decide "questions neither raised nor resolved below").[6]

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[4] Oklahoma erroneously states that the amount of the disallowance upheld by the Board, the district court, and the court of appeals is $7,138,280. Pet. 8. The correct amount is $7,426,672. See Pet. App. 3, 32; App., *infra*, 3a.

[5] The court of appeals observed that, although the district court did not base its decision on the definition of "cost" in Circular No. A-87, it was free to affirm that decision on any ground supported by the record. Pet. App. 8.

[6] Petitioner's petition for rehearing in the court of appeals cited, for the first time, several of the decisions cited in its petition before this Court. That petition, however, did not assert any

In any event, petitioner's claim lacks merit. Petitioner's claim is premised on its contention that the funds intended for deposit in the OSEEGIB Reserve Fund and diverted instead to the Clearing Fund constitute money of State *employees* that has "passed through the pockets of the employees who received the fringe benefits from the State as compensation." Pet. 11. That is not correct. Although State employees choose their health insurance provider, payment of that fringe benefit does not pass through their pockets. When the federal government reimburses the State for the latter's cost of the health benefits of those employees who select the OSEEGIB health plan, the federal funds are paid to the employing State agencies (not to the employees), which then deposit that money directly into the Reserve Fund, Okla. Stat. tit. 74, § 1312(1) (1995), or, as occurred in this case, the Clearing Fund, *id.* § 1310.B (Supp. 2002).

Petitioner likewise is incorrect in suggesting that "employee paid premiums" are at issue here. Pet. i, 5. Only "employer contributions" for employee fringe benefits are allowable costs that may be reimbursed. 60 Fed. Reg. at 26,494. Hence, the federal funds in question reimbursed *petitioner* for the portion of the premiums paid by *petitioner*, not the portion of the premiums paid by the employees through payroll deduction (see Okla. Stat. tit. 74, § 1311 (1995)). Indeed, *employee* contributions to health insurance are not reimbursable at all.

Petitioner further overlooks the essential nature and purpose of a state self-insurance fund, in which losses are absorbed internally. As the Board explained, sound

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constitutional claim, and the court of appeals unanimously denied rehearing, without comment. Pet. App. 9-10.

operation of a self-insurance fund requires that "a fund balance be carried over from year to year" and be "maintained in the form of a reserve fund, which generates investment income and protects the self-insurance plan against unforeseen funding shortfalls," such as underestimation of future health care claims. Pet. App. 24. Indeed, that is precisely what the *State's* Group Insurance Act requires: "all * * * contributions" to the State's self-insurance plan "shall be deposited" in the Reserve Fund and shall be used for payment of "all expenses" and for investment purposes. Okla. Stat. tit. 74, § 1312(1) (1995).

Thus, petitioner's obligation to use federal funds intended to compensate the State for its employees' health benefits was not satisfied merely by using the federal funds to pay insurance premiums.[7] When the federal government reimbursed petitioner for its contribution for the cost of those employee benefits, the federal government expected that such funds would be *deposited and maintained* in the Reserve Fund. The money here at issue, however, was not even deposited, let alone maintained, in the Reserve Fund. Instead, it was transferred directly from the State agency recipients to the newly-created Clearing Fund and used for

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[7] As support for its contention that its obligation to the federal government was fulfilled once the insurance premiums were paid, Oklahoma cites *NYS Health Maintenance Organization Conference* v. *Curiale*, 64 F.3d 794 (2d Cir. 1995). That case, however, had nothing to do with a State self-insurance plan, OMB Circular No. A- 87, or a State's use of federal money intended as reimbursement of the State's costs in administering federal programs. At issue, *inter alia*, was whether a benefits plan administrator had fulfilled his statutory fiduciary duty under the Employee Retirement Income Security Act. *Id.* at 799 n.13.

State education purposes, not the use intended and authorized by the federal government.[8]

This Court has long recognized that the United States has the "power to fix the terms upon which its money allotments to states shall be disbursed." *Oklahoma* v. *Civil Serv. Comm'n*, 330 U.S. 127, 143 (1947). An early opinion of the Comptroller General also makes clear that moneys paid by the federal government to the States in connection with various aid programs "are held in trust by the States for the purposes of the [pertinent federal statutes] until they have been expended for those purposes." 1 Comp. Gen. 652, 655 (1922). Moreover, the States are not entitled to profit from such funds, and any interest that accrues "while the moneys are so held by the States inures to the benefit of the United States as owner of the funds and not to the States as trustees." *Ibid.* See, *e.g.*, *Pennsylvania Office of the Budget* v. *Department of Health & Human Servs.*, 996 F.2d 1505 (3d Cir.) (federal government was entitled to its share of interest earned on self-insurance reserve partly funded with federal money), cert. denied, 510 U.S. 1010 (1993).

Consistent with those principles, OMB Circular No. A-87 establishes the requirements that States must satisfy when seeking reimbursement from the federal government for their costs in administering federal programs. Contributions to State self-insurance plans are allowable and reimbursable, but only so long as

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[8] Indeed, when it established the Clearing Fund, the Oklahoma legislature recognized that it would be funded not only with State appropriated money, but also with "other funds available to such agency for operational purposes," Okla. Stat. tit. 74, § 1310.B (Supp. 2002), which would include federal cost reimbursement money intended for non-educational purposes.

certain conditions are met. 60 Fed. Reg. at 26,498-26,499, 26,502. Because State self-insurance plans are not commercial, for-profit enterprises, the maintenance of an appropriate reserve level is of particular concern to the federal government. The reserve must be adequate to pay claims and administrative expenses, but not excessive. Circular No. A-87 therefore requires reserve levels to be "analyzed and updated at least biennially for each major risk being insured" and to "take into account any reinsurance, coinsurance, etc." *Id.* at 26,499. Excessive reserve levels must be explained and justified. *Id.* at 26,499, 26,502. If funds are transferred from a self-insurance reserve to a State's general fund, the federal government's share of the transferred funds must be refunded to the United States, with interest accruing from the date of the transfer. *Id.* at 26,499.

Based on those requirements, the federal government expected that the funds it paid to petitioner for the health benefits of State employees who worked on federal programs would be deposited and maintained in the OSEEGIB Reserve Fund, so as to ensure adequate funding for future claims. That money retained its federal character, and petitioner's transfer of such funds to nonfederal purposes violated federal appropriations law and Circular No. A-87.

2. The decision of the court of appeals does not conflict with this Court's decision in *Zelman* v. *Simmons-Harris*, 122 S. Ct. 2460 (2002), and other Establishment Clause jurisprudence. Contrary to petitioner's contention, *Zelman* did not involve "the same issue" that is before the Court here. Pet. 17. In that case, the Court ruled that a school voucher program, designed to provide educational choices to families within the Cleveland City School District, did

not violate the First Amendment's prohibition of laws that have the purpose or effect of advancing or inhibiting religion. 122 S. Ct. at 2463; see *id.* at 2465. Under that program, tuition aid is paid directly to parents (on the basis of financial need), and the parents then endorse the checks over to the public or private school in which they have chosen to enroll their child. *Id.* at 2464.

Apart from the facts that the Establishment Clause is in no way implicated in the instant case, and that federal reimbursement of State costs under Circular No. A-87 was not involved in *Zelman*, there are other critical differences between the two cases. Unlike *Zelman*, no "government funds [are] paid to private individuals" in this case. Pet. 17. As explained above, the federal government reimburses the State agencies for the costs they incur in administering federal programs, including State employee health benefits. The State employees who work on such programs are entitled to choose their health insurance plan, but they do not receive any federal funds. Moreover, unlike the State agencies that do receive such funds, State employees are not "responsible for the efficient and effective administration of Federal awards through the application of sound management practices." 60 Fed. Reg. at 26,490.

3. Petitioner also mistakenly argues that the federal funds here at issue lost their federal character under the "supervision and control" test applied by some circuits. Under that test, the courts examine "the basic philosophy of ownership reflected in the relevant statutes and regulations," and "the supervision and control contemplated and manifested on the part of the [federal] government." *United States* v. *Long*, 996 F.2d 731, 732 (5th Cir. 1993) (quoting *United States* v.

Evans, 572 F.2d 455, 472 (5th Cir.), cert. denied, 439 U.S. 870 (1978)). "[W]hen an outright grant is paid over to the end recipient, utilized, commingled or otherwise loses its identity, the money in the grant ceases to be federal." *United States* v. *Hope*, 901 F.2d 1013, 1019 (11th Cir. 1990) (quoting *United States* v. *Smith*, 596 F.2d 662, 664 (5th Cir. 1979)), cert. denied, 498 U.S. 1041 (1991).

The federal funds involved in this case amply satisfy the supervision and control test. Circular No. A-87's numerous references to and requirements concerning State self-insurance funds and their reserves demonstrate the federal government's supervision, control, and significant continuing interest in how federal money deposited in such funds is managed and used. Further, that money is not paid to the State as "an outright grant," but rather comes with strings attached, as set forth in the Circular. Thus, petitioner's suggestion that this case is about "private choice" in the use of funds provided by the federal government, but over which the government has no continuing supervision, Pet. 19, is without basis.[9]

4. Petitioner also errs in suggesting for the first time in this Court that the conditions imposed on the federal funds it received were not "unambiguously expressed" in its "contract" with the federal government—*i.e.*, "the four corners of OMB [Circular No.]

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[9] It bears noting that Circular No. A-87 and the disallowance determination here have no impact whatsoever on the employee's choice of health insurance. Petitioner remains free to offer a flexible benefit allowance, which permits its employees to choose health and other insurance from either the OSEEGIB or a private insurer. Petitioner is restricted only in what *it* may do with federal funds used to purchase benefits from the State-operated insurance plan.

A-87." Pet. 21, 22.[10] Circular No. A-87 sets forth in detail a State's obligations respecting its use of federal funds obtained as reimbursement for the costs of insurance provided by the State's own self-insurance fund and, in particular, the management of a self-insurance reserve. Pp. 3-4, *supra*. Petitioner's claim that it did not have adequate notice of such obligations is therefore wholly lacking in merit.

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted.

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[10] In this connection, Oklahoma argues that the court of appeals' decision conflicts with *Barnes* v. *Gorman*, 122 S. Ct. 2097 (2002), which held that punitive damages are not available in private suits brought under the Americans with Disabilities Act and the Rehabilitation Act. *Id.* at 2103. In analogizing that Spending Clause legislation with a contract for federal funds, the Court noted the well established principle that, "if Congress intends to impose a condition on the grant of federal moneys, it must do so unambiguously." *Id.* at 2101 (quoting *Pennhurst State Sch. & Hosp.* v. *Halderman*, 451 U.S. 1, 17 (1981)). Apart from that quotation, however, *Barnes* has no relevance to this case.

UNITED STATES DISTRICT COURT
FOR THE WESTERN DISTRICT OF OKLAHOMA

No. CIV-00-316-W

STATE OF OKLAHOMA EX REL. OFFICE OF STATE FINANCE, PLAINTIFF

v.

TOMMY G. THOMPSON, SECRETARY OF HEALTH AND HUMAN SERVICES EX REL. DEPARTMENT OF HEALTH AND HUMAN SERVICES, AND UNITED STATES OF AMERICA, DEFENDANTS

[Filed: July 18, 2001]

ORDER

The plaintiff, State of Oklahoma ex rel. Office of State Finance ("State"), brought this action seeking judicial review under the Administrative Procedures Act ("APA"), 5 U.S.C. § 706(2), of a decision issued by the Departmental Appeals Board ("DAB") of the United States Department of Health and Human Services. The State and the defendants, Tommy G. Thompson, Secretary of Health and Human Services ex rel. United States Department of Health and Human Services ("HHS"), and the United States of America, have submitted argument and authority in support of their respective positions. Based upon these submissions, the Court makes its determination. In so doing, the Court has not set forth a detailed recitation of the

events giving rise to the instant controversy since the essential facts are undisputed and are sufficiently set forth in the parties' papers.

State employees may elect to receive health, disability, life and other benefits through the Oklahoma State and Education Employees Group Insurance Board ("OSEEGIB"), a self-insurance program that is governed by the State and Education Employees Group Insurance Act ("SEEGIA"), 74 O.S. §§ 1301-1327. Many state employees work on federally-funded programs, and the federal government has annually paid funds to the state agencies administering federal grants or federal-state programs to reimburse them for a portion of their employer contributions to the OSEEGIB. The federal and state funds that constitute the agencies' share of premiums are deposited into the State Employees Group Insurance Clearing Fund ("Clearing Fund"). These funds are in turn deposited in the appropriate OSEEGIB reserve account and used to pay employees' claims or administrative expenses, or used to generate income.

In 1996, the Oklahoma legislature amended the SEEGIA so that in fiscal year 1997, the first $31.5 million deposited into the Clearing Fund was distributed to the Oklahoma State Regents for Higher Education to pay the expenses of the State's higher education system. 74 O.S. § 1312.3(1). The remainder was then distributed to and deposited in the appropriate OSEEGIB reserve account. *Id.* § 1312.3(2).

Acting on its belief that federal funds paid to state agencies on behalf of employees working on federally-funded programs were being used for an unauthorized purpose, HHS's Division of Cost Allocation sought repayment of the allegedly diverted funds. On October

8, 1997, HHS formally notified the State of HHS's determination that the State had violated the cost allocation provisions of United States Office of Management and Budget ("OMB") Circular A-87, as revised. By letter dated January 29, 1998, HHS disallowed $7,426,672.00[1] of federal funds paid to the State, plus interest.

On February 27, 1998, the State appealed to the DAB.[2] On August 18, 1998, the DAB issued Decision No. 1668, sustaining the disallowance of those federal funds received by the State for a portion of the costs of group health insurance premiums paid on behalf of state employees and diverted to higher education programs, but reversing the disallowance of the amount claimed as interest.

The DAB found:

> "The federal government awarded the disallowed funds to pay a portion of Oklahoma's employer contributions for health insurance for its state employees, to the extent that those employees work on

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[1] The original disallowance totaled $20,412,088.00. That amount was eventually reduced to $7,715,064.00, which HHS contended represented the federal share of the $31.5 million transfer ($7,426,672.00) and earned or imputed interest ($288,392.00).

[2] In its appellate brief, the State characterized the matter as follows:

> "The disallowed costs arise from the State's use of $31.5 million collected by the . . . OSEEGIB . . . during the fiscal year ended June 30, 1997. The State used this money to fund needed expenditures in the State's system of higher education. The amount transferred from OSEEGIB consisted of the first $31.5 million of employer contributions for group health insurance premiums for state employees received by OSEEGIB in the fiscal year."

> federally funded programs. Oklahoma would ordinarily have deposited the premiums into the OSEEGIB reserves, where they would have generated income and been used to pay health insurance claims and other related expenses. . . . Instead, Oklahoma removed the funds from its group insurance system and used them to pay the costs of higher education.
>
> "The higher education expenditures were not necessary and reasonable for the provision of health insurance for state employees working on federal programs, the purpose for which the funds were awarded. The high education costs did not benefit and consequently were not allocable to those federal awards. The education costs were thus not allowable charges to federal awards under OMB A-87.
>
> "By using the federal funds for higher education expenses, Oklahoma also violated the basic principle of appropriations law that federal funds must be used for the purposes for which they are awarded. Additionally, the various federal program statutes and regulations (and appropriation statutes) that authorize the use of federal funding for payment of administrative costs require that the funding be used only for the authorized programmatic purpose. . . ."

DAB Decision No. 1668 (August 18, 1998) at 4 (citation and footnote omitted).

This Court's review of the DAB's decision is governed by the APA,[3] and the Court must uphold this

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[3] Because this Court's review is limited to the administrative record, *see* Order at 2-3 n.3 (August 31, 2000), the Court has not

decision unless it finds that the decision is "arbitrary, capricious, an abuse of discretion, or otherwise not in accordance with law," 5 U.S.C. § 706(2)(A), or that it is "unsupported by substantial evidence. . . ." *Id.* § 706(2)(E). "To make this finding the [C]ourt must consider whether the decision [is] . . . based on a consideration of the relevant factors and whether there has been a clear error of judgment." *Citizens to Preserve Overton Park, Inc.* v. *Volpe*, 401 U.S. 402, 416 (1971) (citations omitted). The "standard of review is a narrow one," *id.*, and "[t]he [C]ourt is not empowered to substitute its judgment for that of the agency." *Id.* Rather, the Court must determine whether "the agency . . . examine[d] the relevant data and articulate[d] a satisfactory explanation for its action including a 'rational connection between the facts found the choice made.'" *Motor Vehicle Manufacturers Association of the United States, Inc.* v. *State Farm Mutual Automobile Insurance Co.*, 463 U.S. 29, 43 (1983) (quoting *Burlington Truck Lines, Inc.* v. *United States*, 371 U.S. 156, 168 (1962)).

If the decision involves the interpretation of an agency's own regulations, that interpretation must be given "substantial deference," *Thomas Jefferson University* v. *Shalala*, 512 U.S. 504, 512 (1994) (citations omitted), and ""controlling weight unless it is plainly erroneous or inconsistent with the regulation,"" *Id.* (quoting *Udall* v. *Tallman*, 380 U.S. 1, 16 (1965) (quoting *Bowles* v. *Seminole Rock & Sand Co.*, 325 U.S. 410, 414 (1945))).

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considered the Affidavits of Tam Daxon (February 12, 2001, and June 19, 2001) or the Declaration of Terry D. Hill (April 26, 2001).

The principle that federal "[a]ppropriations shall be applied only to the objects for which the appropriations were made . . .," 31 U.S.C. § 1301(a), is embodied in OMB Circular A-87, which was issued as a guideline to government agencies for determining allowable costs incurred by the State under grants, cost reimbursement contracts and other agreements with the federal government. To be allowable, costs must, inter alia, "[b]e necessary and reasonable for proper and efficient performance and administration of [the grants, cost reimbursement contracts, and other agreements with the federal government], OMB A-87, Attachment A ¶ C.1.a, and they must "[b]e allocable," *id.* Attachment A ¶ C.1.b, to the same. "A cost is allocable to a particular cost objective if the goods or services involved are chargeable or assignable to such cost objective in accordance with relative benefits received." *Id.* ¶ C.3.a.

The Court has carefully considered the State's challenges to the DAB's decision and in particular has examined the State's arguments (1) that the DAB relied upon a DAB decision, *Texas Office of the Governor*, DAB No. 1608 (1997), that was ultimately vacated, *Texas* v. *United States Department of Health and Human Services*, No. A 99-CA-056 SS (W.D. Tex. Aug. 28, 2000); (2) that the DAB relied on facts not present in the record; (3) that the DAB failed to fully develop the record and failed to obtain allegedly critical testimony;[4] (4) that the DAB applied an incorrect legal standard and made errors of law; and (5) that the DAB engaged in speculation in arriving at its decision.

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[4] There is no evidence in the record that the State was denied the opportunity to present any evidence or arguments it deemed critical to the issues before the DAB.

Under the standards which govern its review, the Court finds the challenged decision is neither arbitrary or capricious, nor an abuse of discretion; it is in accord with federal cost allocation principles and is based on substantial evidence. *E.g.*, *Dickinson* v. *Zurko*, 527 U.S. 150, 162 (1999) ("substantial evidence" standard requires court to ask whether "reasonable mind might accept" particular evidentiary record as "adequate to support a conclusion"). The DAB applied the correct legal standards, and the Court finds no argument advanced by the State warrants the relief the State has requested.

Accordingly, the Court

(1) AFFIRMS in all respects DAB Decision No. 1668 issued on August 18, 1998; and

(2) ORDERS that judgment issue in favor of HHS and the United States forthwith.

ENTERED this 18th day of July, 2001.

/s/ LEE R. WEST
LEE R. WEST
United States District Judge